

Financial misreporting in UK charities

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Acknowledgments

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Table of Contents

Acknowledgments.....	2
Table of Contents.....	4
List of Tables	7
List of Figures	7
Abstract.....	8
Chapter 1: Introduction and Background.....	10
1.1 Research background.....	10
1.2 The motivation for this research.....	11
1.2.1 The increasing relevance of the sector	13
1.3 Research gap	14
1.4 Research questions and contribution of the study.....	14
1.5 Overview of charity sector accounting	19
1.5.1 Statement of financial activities (SoFA)	20
1.5.2 Unrestricted and restricted funds.....	23
1.5.3 The Statement of Financial Position – The Balance Sheet	25
1.6 Motives for earnings management.....	26
1.7 Alternative techniques of earnings management	27
1.7.1 Real Activities Earnings Management (REM)	28
1.7.2 Accruals based Earnings Management (AEM)	29
1.7.3 Classification shifting earnings management.....	31
1.8 Empirical evidence of earnings management	31
1.9 Financial misreporting in charities.....	33
1.10 Motives for financial misreporting in charities.....	38
1.10.1 Retention and perpetuation of funding.....	38
1.10.2 Tax exemption	39
1.10.3 Managers' career aspirations	40
1.10.4 Debt covenants	40
1.11 Summary	41
Appendix 1.1: Statement of Financial Position (SoFA).....	42
Appendix 1.2: Balance Sheet	43
Chapter 2: Study on the Motivators of Financial Statement Misreporting in the UK Charity Context	44
2.1 Introduction.....	44
2.2 Theoretical framework	46
2.2.1 Agency theory	47
2.2.2 Resource dependency theory.....	48

2.2.3 Legitimacy theory	49
2.3 Literature on financial misreporting in the charity sector	51
2.4 Methodology	57
2.5 Analysis of results: Motivations for financial statements misreporting	61
2.5.1 Preservation of future Income	65
2.5.2 Misreporting facilitators	83
2.6 Conclusion.....	89
Appendix 2.1: Interview questions guide.....	95
Chapter 3: Study on Accruals-based and Real Activities Earnings Management by UK Charities.....	96
3.1 Introduction.....	96
3.2 Literature review and hypotheses development.....	99
3.3 Data and sample	108
3.3.1 Sample.....	108
3.3.2 Classification of nonprofits	109
3.4 Manipulation measures.....	110
3.5 Descriptive statistics	113
3.6 Hypotheses testing	115
3.6.1 Accrual manipulation	115
3.6.2 Real accounts manipulation	125
3.7 Robustness tests	133
3.8 Conclusion.....	134
3.9 Limitations and future research.....	136
Appendix 3.1: Figures.....	137
Appendix 3.2: International Classification of Nonprofit Organizations (ICNPO).....	138
Chapter 4: Study on Expense Misclassification: Evidence from UK Charities.....	139
4.1 Introduction.....	139
4.2 Theoretical background	144
4.3 Literature review and hypotheses development.....	147
4.4 Research Design	157
4.4.1 Sample selection.....	157
4.4.2 Descriptive statistics.....	158
4.4.3 Methodology	162
4.5 Results	168
4.5.1 Estimation using McVay model	168
4.5.2 Estimation using Yetman model.....	170
4.5.3 Estimation using combined model.....	172
4.5.4 Expense shifting hypothesis (H1).....	178

4.5.5 Effect of sophisticated donors (H2)	181
4.5.6 Effect of service-oriented charities (H3).....	182
4.5.7 Effect of ratios hypothesis (H4)	185
4.5.8 Support cost hypothesis (H5)	188
4.5.9 Additional analysis	191
4.6 Robustness Tests.....	196
4.6.1 Alternative charity categories	196
4.6.2 Alternative definition of suspect firms	197
4.6.3 Alternative CAE variable	197
4.6.4 Alternative deflator	198
4.6.5 Alternative control variables	198
4.6.6 Alternative UE_FR and UE_CAE prediction variables	198
4.6.7 Alternative measure of high support cost	198
4.7 Conclusion.....	199
Chapter 5: Conclusion.....	202
5.1 Introduction.....	202
5.2 Motivations for financial misreporting by UK charities	202
5.3 Earnings management in charities.....	204
5.4 Expense misclassification in charities	205
5.5 Limitations and further research	206
References	211

List of Tables

Table 3.1	Descriptive Statistics	115
Table 3.2	Panel A: Spearman (Below)/Pearson (Above) Correlation Matrix (AEM)	115
Table 3.2	Panel B: Spearman (Below)/Pearson (Above) Correlation Matrix (REM)	116
Table 3.3	Estimation models results	119
Table 3.4	Tests of accrual manipulation in charities	121
Table 3.5	Tests of accrual manipulation in charities by direction of manipulation	122
Table 3.6	Tests of accrual manipulation in charities related to type of funders	124
Table 3.7	Test of real manipulation in charities	129
Table 3.8	Test of real manipulation in charities related to type of funders	132
Table 4.1	Descriptive statistics and the correlation matrix	160
Table 4.2	Estimation models for normal levels of FR and CAE	175
Table 4.3	H1 results	179
Table 4.4	H2 and H3 results	183
Table 4.5	H4 results	186
Table 4.6	H5 results	189
Table 4.7	Programme ratio - additional results	193

List of Figures

Figure 1.1	Sub-grouping of types of funds of a charity	25
Figure 1.2	Earnings management versus fraudulent accounting	33
Figure 1.3	Charitable sector context	34
Figure 1.4	Costs to charities for posting high surpluses or deficits	38
Figure 2.1	List of charities	60
Figure 3.1	EBDA and net income histograms	138

Abstract

The thesis consists of three separate studies related to financial misreporting in UK charities. The first study investigates whether large UK charities misreport numbers in their financial statements, and if so what motivates them in doing so. Using semi-structured interviews of eleven finance directors of charities, two auditors and a banker, I find that it is predominantly funding pressure that generates incentives for the misreporting of financial accounts in large UK charities. In addition to traditional agency theory, I look at this topic through the prisms of resource dependency and legitimacy theories. I focus on three important areas of charity accounting reporting: reserves, fundraising costs and bottom-line net incoming resources.

In the second study, I provide empirical evidence about the extent to which charities engage in accrual and real-based manipulation. The sample consists of charities that report to the Charity Commission for England and Wales over the period 2007 to 2016. I find evidence that charities manipulate their bottom-line income figure to achieve a target benchmark of a small surplus. By categorising the sector according to the predominant funding type and funders' sophistication, I also find that the sophistication of funders is positively associated with financial reporting quality. The donor-beneficiary separation in charities increases the likelihood of real earnings management; whereas for the service-oriented charities where the funders are also the users of a charity's services, there appears to be an increased appetite for manipulation through accruals-based earnings management. Overall, I provide empirical evidence on earnings management in a little-researched sector that is widely regarded as beyond reproach.

In the third and final study, using the same sample as in the second study, I present evidence of expense misclassification in UK charities between 'good' the programme costs and 'bad' the fundraising expenses. Employing three prediction models, I consistently find a strong negative relationship between unexpected levels of fundraising and unexpected programme costs. I further study the impact of the charity and donor types on the nonprofit managers' willingness to misclassify expenses. The

relationship becomes less negative for the nonprofits supported by more-sophisticated funders and those with lower donor-beneficiary separation. This suggests that donor sophistication and lower donor-beneficiary separation reduce the appetite for misclassification as funders have access to sources other than just the financial reporting one to gauge a charity's efficiency. Among various expense ratios, the nonprofit managers appear more willing to misclassify expenses when a charity has a low 'programme ratio' within its peer group. I do not find evidence that a high support cost is a compelling prerequisite for misclassification.

Chapter 1: Introduction and Background

In the first part of this chapter, I present the research background, followed by the motivation for the research and the gap in the current literature. This leads to the research questions and contribution of the research.

The second part of the chapter presents an overview of accounting in the charity sector and a background on earnings management, as well as on financial misreporting in charities.

1.1 Research background

This study is a vital addition to the scant academic literature on earnings management and expense misclassification in nonprofit organisations and particularly in the charity sector in the UK. Earnings management in nonprofit hospitals has been the focus of prior literature. This study conducts an in-depth examination of the behaviour of UK charity sector organisations in England and Wales to establish whether there is evidence that managers of these charities manipulate earnings and practise expense classification shifting in their financial statements. This research covers all commonly known aspects of financial misreporting by charities employing qualitative and quantitative techniques.

There is no one specific definition for earnings management in the extant literature, which covers various forms and aspects of this phenomenon; however it could be described as follows: “*earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers*” (Healy 1985, p.368). Schipper (1989) views earnings management as a purposeful intervention in the financial reporting process to obtain some private gain.

The practice of earnings management in corporations has been extensively reported by researchers. The quality of financial information, and more specifically earnings quality, has been a focus of considerable attention from academics and practitioners. This rich body of research has primarily focused on US corporations, partially because the speech by the prior Chairman of the Securities and Exchange Commission, Arthur Levitt in September 1998 prompted many interested researchers and practitioners to investigate manipulation in accounting numbers and disclosures in annual reports with

a renewed vigour and resolve. Levitt's report shone a bright light on the Securities and Exchange Commission's (SEC) concerns and it was not an accident that this report was titled "The numbers game" (Levitt, 1998).

The main motive for the existence of corporations is to maximise shareholders' wealth; any action by management which results in either preserving that main objective or for their personal gain through manipulating accounting numbers can loosely fall within the realm of earnings management.

After the huge scandals of World Com and Enron at the turn of the century which led to the downfall of those two energy giants and also became triggers for the demise of one of the then top-five audit firm, Arthur Anderson, one would have assumed that the news of earnings management would be a thing of the past. In a Wall Street Journal's report, Eaglesham and Rapoport (2015) allude to the fact that the investigations by the SEC had increased again in comparison to the previous year into "cooking the books" type offences; however, the new cases were reported to be on a smaller scale and were generally less egregious than the big scandals at the start of this century. As far as research in earnings management in private sector corporations is concerned, the US has been the focus of attention for researchers. This is unsurprising when research in accounting, in general, has been far more prevalent in the US than anywhere else in the world. However, research on the topic in charities and not-for-profit organisations is scarce. Therefore this study aims to fill the gap in the research. This study aims to investigate what motivates managers to manipulate financial numbers and whether charity types and predominant funding type impact manipulation behaviour. This study will be beneficial for stakeholders of UK Charity sectors such as donors, the government, volunteers and the public at large who are heavily involved with the sector in various capacities as customers, donors, beneficiaries, employees, volunteers, etc. Similarly, the media is also an important stakeholder group (NCVO, 2014).

1.2 The motivation for this research

The nonprofit sector is an indispensably significant part of society that provide services which are not directly provided either by the state or the for-profit sector. Such a big

gap is covered by over 168,000 independent charities in the UK.¹ The success of a sector that provides a whole host of services to those who most need it requires its funding from public and private sector that includes corporations and individuals. The services range from local alleviation of poverty to providing clean drinking water in a far-flung region of the world, from reserving art and culture to promoting good through religion. The purpose of all charities is not to make a profit but it is their social impact that keeps them distinct from the other two sectors. For all of these to have a maximum impact and full support, they consistently rely on public trust. Their reliance on public trust is to the extent that nonprofits may be judged by higher standards than for-profit organisations (Sisco, 2012). Charities need to work extra hard in maintaining and perpetuating such trust.

Despite the necessary high degree of trust, there has been a noticeable nation-wide drop in trust by the public towards the sector which has been facing an increasing number of scandals in the UK and worldwide. The Charity Commission has flagged that auditors of the UK charities are “letting down” their profession and only half of a sample of charity accounts met the required standards in 2017.² This is a matter of justifiable concern for donors, the public, the accounting profession and the regulator. The cost of fraud to the charities sector in the UK was at a ten-year high in 2018. The fraud within charities that were reported increased by more than 120% and was the highest reported value for the sector since 2009; even those reported maybe only 2% of the actual number of frauds.³ This challenges the notion of inherent nonprofit trust (Prakash & Gugerty, 2010).

One logical impact of loss in trust in the sector which survives and thrives through public and private support is the loss in funding and sustainability of its financial support. The extant literature confirms that erosion of faith can lead to lower individual giving and reduced public support for the nonprofit sector (Rose-Ackerman 1996; Bekkers 2003; Steinberg 2006). A possible consequence for the loss is trust is that people may become sceptical whether the nonprofits’ claim of fulfilling their purpose

¹ Charities in England and Wales –(Accessed 20/04/2020)

<https://apps.charitycommission.gov.uk/showcharity/registerofcharities/SectorData/SectorOverview.aspx>

² <https://www.gov.uk/government/publications/accounts-monitoring-review-auditors-and-independent-examiners-compliance-with-their-responsibilities/auditors-and-independent-examiners-compliance-with-their-responsibilities>

³ <https://www.bdo.co.uk/en-gb/news/2019/fraud-in-charities-sector-hits-ten-year-high>

of delivering for the public good may no longer be taken on faith. *“more people believe they have a stake in the accountability of nonprofits”* (Brody 2002, p. 472).

1.2.1 The increasing relevance of the sector

The charity sector is indispensable for the economy for several reasons. A number of services such as education, health, social services, religious practices, including senior citizens, to name a few are essential. Each sub-group of charities has its own challenges and work needs to be done to remove inequalities within the society. It is fundamentally important that the funding reaches where it is intended for, through effective and efficient management of resources. As discussed above, the extant literature provides evidence that accounting numbers can influence the levels of funding. This is the prime reason to investigate this important area to establish whether charities misreport to enhance their income.

Over £76bn of income reaches the sector every year through public and private support; hence there is a large economic value and intangible impact associated with the sector. A UK taxpayer can boost the amount of every donation by giving through Gift Aid, an Income Tax relief to help charities receive more funds than they are donated. This is effectively taxpayers' money and therefore it is in the general public's interest that the sector operates legitimately and returns good value for money through providing service efficiently. The Gift Aid scheme adds 25p to each £1 paid by a UK taxpayer at no extra cost to the funder directly, but it is returned by Her Majesty's Revenue and Customs (HMRC).⁴

During the time of global crisis posed by the COVID-19 (Coronavirus) outbreak, this study becomes even more relevant wherein the depleting governmental and private resources need to be allocated responsibly and at the same time when the need is more than ever before on a global scale. The relevance of the UK charity sector is not limited to the UK alone, but its impact is truly global and more so when it is most needed in the most destitute parts of the world as well as within the developed world which is facing an unprecedented crisis. This study is an effort to investigate whether charities are motivated to misinform through their financial statements and if so what

⁴ Her Majesty's Revenue and Customs - A non-ministerial department of the UK Government for the collection of taxes.

are the possible ways of doing so. A mixed-methods approach is used, given the social constructs associated with the precise accounting numbers. Both quantitative and qualitative factors need to be considered before reporting with reasonable confidence on whether charities act in an inappropriate manner vis-à-vis their financial reporting to influence funders to compete in a challenging industry.

1.3 Research gap

To my knowledge, there has not been a comprehensive study that investigates the most used methods of earnings management in the charitable sector setting. Misclassification between expenses also has not been studied directly to my knowledge. Where prior nonprofit literature does study the impact of poor expense reporting quality on income, it generally implies misclassification between fundraising and charitable expenses. The misclassification between the two broad expense types has not been explored in one study before. Details of the expense types are explained in the later sections. Similarly, the amount of literature covering the sector in the UK setting is scant. To my knowledge, semi-structured interviews have not been employed for an in-depth understanding of the motivations associated with manipulation, either in the UK or even the US setting, where most of the nonprofit accounting research is focused.

1.4 Research questions and contribution of the study

The thesis is divided into three separate studies that investigate different aspects of charitable financial misreporting.

The first study in the thesis investigates the factors that motivate managers to misreport financial statements in UK charities that are established for charitable purposes as defined by the Charities Act 2011 and registered with the Charity Commission, the regulator of the sector in England and Wales. Most of my findings confirm the existing theory in UK context using semi-structured interview approach. I find that high levels of reserves may be averted by charities' managers. Similarly rising overhead costs can also pose challenges and need careful allocation, so that donors do not view the charity in a bad light. This increases the possibility that most costs are allocated, some subjectively, as charitable activities expenses. I find that incognizant

users of financial statements, inexperienced, less qualified and incompetent trustees, peer benchmarking, debt covenants, job security and sustained employment are strong factors in enticing management to manipulate financial statements. The study of the entire sector is not without its challenges as various charity-specific attributes contribute to a complex mix of challenges. Hence, predicting financial reporting choices is not straight forward and conclusive through testing a large dataset. Since most charities are funded through a mix of sources and each source has its preferences towards how the charity spends its funds; furthermore, there is a growing trend from voluntary to more earned income. This poses challenges for charities to appear 'financially viable'. I also find that the income/expense period mismatch causes a situation where the net surplus/deficit is likely erratic, a state that most users of financial statements are uneasy about. In addition, I find that the presence of some facilitators increases the possibility of window-dressing. An important contribution of this research is to highlight that the audit quality in charities is of a substandard quality and less vigorous than their for-profit counterparts. A charity that is funded by unsophisticated funders is more likely to manage earnings as the donors do not fully recognise the intricacies and true costs of running a charity. This also means that the monitoring mechanism is lacking which sophisticated finders may offer, giving charities the leeway and freedom to manipulate.

This study contributes in several ways to the limited literature on financial reporting quality in UK charities. To my knowledge methodologically it is the first study of its kind, as financial reporting quality has not been studied through in-depth semi-structured interviews with heads of finance in large charities. Again, to my knowledge prior to this research no studies have exclusively focused on the motivations that managers face in manipulating financial statements. There have been consistent developments in accounting in general and the realms of charity accounting in particular over the last decade. There are no studies to my knowledge exploring in-depth a wide spectrum of manipulation in charities. The first study attempts to answer two simple but open-ended questions. Firstly, whether UK charities have motivations to manipulate their financial statements, and if so, which numbers are fixated on? Secondly, if particular factors facilitate such manipulation?

In the second study, I empirically examine the prevalence and extent of accrual and real manipulation in a sample of UK charities over the period 2007-2016. find that UK

nonprofits manage earnings towards a small surplus benchmark after observing pre-managed earnings on either side of the benchmark. I find that the pursuit for loss avoidance is more pronounced compared to the large surplus aversion. I also observe that the charities funded by more sophisticated funders tend to manipulate less towards a target range, hence suggesting that managers recognise that sophisticated donors are aware of earnings management hence it would be counterproductive for sustaining future donations. This result is in contrast to Parsons et al. (2017) who do not find that donor restriction affects earnings manipulation.

Another finding of my research in the second study points to the preferences of different earnings management types. I find that the accruals-based earnings management is more prevalent in more service-oriented charities, where the donor-beneficiary distance is small. In contrast, I find that the real activities earnings management is a preferred course for more charitable nonprofits that have an implied lower donor-beneficiary proximity and lower programme service revenue. Therefore, pressure to manipulate earnings is more likely through a recognised costlier form of earnings management i.e. real activities earnings management. I find that charities that are mostly funded by endowments are less likely to manipulate bottom-line income. That service-oriented charities are less likely to manipulate using REM could be because a low donor-recipient separation would make abnormal changes to fundraising costs more noticeable and hence reducing their benefit from management's perspective as a tool for earnings management.

The oversight for real spending appears better for service-oriented charities, presumably, due to a low donor-recipient separation, through better supervision of charity funds. Possibly, less affinity for real accounts manipulation points to a better awareness of the adverse effects of this on future performance compared to the accounting-based earning management. Due to the implied large donor-beneficiary separation, financial statements are more relevant for the donors of charitable nonprofits, those that are expected to receive free donations rather than services or products in exchange. Similarly, service-oriented charities may be less interested in real earnings management as their service are more commercial type due to their contracts. I expect that they would find real earnings management on balance disadvantageous for their overall objectives. As accruals earnings management does

not have a practical impact on the wellbeing of an organisation, it may be lesser of the two evils.

The second study makes a significant contribution to the nonprofit accounting literature. To my knowledge, this is the first study that investigates earnings management in a sample of all charities that meet the audit threshold criterion, as well as examines the behaviour between more service-oriented and their charitable nonprofit counterparts. The second study also confirms the findings in prior literature that more sophisticated funders discount poor quality financial statements.

This study contributes to a limited accruals-based earnings management and “real” activities earnings management literature in a nonprofit setting. It contributes in understanding whether charity types determine preferences of earnings management approaches. The sector is complicated and studying all charities together cannot be generalised at an individual level but provides a good starting point to establish the prospect of a particular earnings management approach for a particular charity. This is because there are various combinations, i.e. some service-oriented charities may have a large element of public donations and there may or may not be donation restriction. This study is useful as it uses the classification method by Balsam and Harris (2014) and studies two broad types of charities in addition to their predominant funding types, the more and less sophisticated. To the best of my knowledge, this is the first study which investigates exclusively the effect of predominantly large endowment funds on both types of earnings management approaches. The study is also the first that divides the sample with regards to donor sophistication and donor-beneficiary separation, and studies the impact on accruals-based and real activities earnings management. I use two measures to investigate sophistication of funders and find similar results (ratio of restricted funds and ratio of endowment funds).

The third and final study looks into a uniquely relevant situation for nonprofits i.e. expense misclassification. The findings suggest that unexpected fundraising costs are significantly negatively associated with unexpected charitable activities expenses using three separate prediction models. I find this shifting to be less prominent when a charity is funded more by sophisticated funders. A more service-oriented charity that receives a higher level of programme service revenue is also less keen to misclassify expenses. Although all charities seem to be engaged in misclassification, the low

donor-beneficiary separation does reduce the willingness to misreport expenses. I assert that it would possibly be because donors can directly observe the level and quality of services. I find that the charities that receive higher restricted income funding are less likely to misclassify their fundraising costs as charitable activities expenses. I infer that a sophisticated funder does not superficially depend on reported numbers and that management is aware of this. The average donor on the other hand is unable to detect misclassification, therefore takes the expense ratios on the face value. This points to management's assertion that a less sophisticated donor is more sensitive to unfavourable expense ratios, the ratios that in their view cast doubt over such charity's 'legitimacy'. Although the results convincingly suggest that types of funders and charities are important factors in predicting whether a charity is susceptible to misclassifying its expenses, the impact of the prevailing expense ratios is mixed on the willingness to misclassify. Contrary to my a priori expectation, I do not find that high support costs on its own is a factor to convince management to misallocate. This finding is in contrast to the finding in the first study where rising overhead costs can be a factor in manipulation. There is a possibility that it shows donors and nonprofit managers are becoming aware that the mere presence of support costs does not guarantee expense classification shifting.

In the third study, I contribute to the scant literature in two broad ways. Firstly, methodologically and secondly, by providing evidence of expense misclassification between fundraising and charitable activities expenses. In addition, I present the effect of more service-oriented and more sophisticated charity types on the prospect of the expense misclassification. Compared to classification shifting in for-profit firms, nonprofits are scrutinised more by media and the public to allocate most of their resources to the main charitable purpose for what a nonprofit exists for. I report that such misclassification does take place. Hence, it is an important study that should interest regulators, donors and nonprofit managers. This is to my knowledge the first study investigating whether funders' sophistication and donor-beneficiary separation are mitigating factors for misclassification between "unfavourable" (fundraising) expenses and "favourable" (charitable) expenses. Another contribution of this study is to investigate whether unfavourable expense ratios influence the prediction for such manipulation.

This research is an in-depth analysis of the UK charity accounting manipulation and in many ways it is the first study to use qualitative and quantitative methods with a large dataset, the largest that has been used in the sector using UK data. The three studies in this thesis are independent in their approach and answer different questions, yet probe the common theme of financial reporting quality across UK charities.

1.5 Overview of charity sector accounting

This section introduces the elements in the charity sector accounting, which on the one hand have several similarities to those of the for-profit sector firms, whilst on the other are in many ways different from the for-profit sector financial statements.

It is a charity's trustees' obligation to prepare the financial statements according to section 162 of Charities Act 2011. Part 8 of the Charities Act 2011⁵ specifies the requirements of keeping accounting records including the form and contents that are required for presenting. Section 132 of the Act states *"The charity trustees of a charity must (subject to section 133) prepare in respect of each financial year of the charity a statement of accounts complying with such requirements as to its form and contents as may be prescribed by regulations made by the Secretary of State."*⁶

An incorporated charity is also required to prepare the financial statements in light of the Companies Act 2006 to fulfil its requirements of staying registered with the Companies House. A charity can choose between receipts and payments accounts or accruals accounts. The accruals accounts must be prepared, according to Charities Statement of Recommended Practice (hereafter, SORP) (FRS 102) which applies to charities that prepare financial statements following the Financial Reporting Standard applicable in the UK and Republic of Ireland. All charities above the gross annual income of £250,000 must produce accruals accounts. Therefore, my sample charities for this study all produce accruals accounts. The charities earning over one million pounds a year require a statutory audit of their accounts by a registered auditor. Trustees are required to prepare accounts following the SORP FRS 102 since 1 January 2016. The minimum audit income threshold was raised from £0.5 to £1m gross income for accounting periods beginning on or after 1 January 2016. My sample

⁵ <http://www.legislation.gov.uk/ukpga/2011/25/part/8>

⁶ S. 132(1) applied (1.1.2018) by The Charitable Incorporated Organisations (Conversion) Regulations 2017 (S.I. 2017/1232), regs. 1(1),

includes all charities which have been auditable since the first year of the data, 2007. It is because the lowest gross income in my data is £0.5m; therefore, representing all firm years in which charities must have undergone a statutory audit. Similarly, if a charity's gross assets exceed £3.26m then the gross income will need to be only £250,000 for it to meet the statutory audit threshold.

From the legal perspective for reporting, The Charities (Accounts and Reports) Regulations 2008 is the current regulation for charities to comply with. The Charities (Accounts and Reports) Regulations 2008 requires charities to prepare their financial statements according to the UK Generally Accepted Accounting Practice (GAAP) on a true and fair basis. Any departure from this ubiquitous prerequisite is against the law and hence should be investigated, which is the primary purpose of this thesis.

With regards to the SORP, it is important to note that it is not an accounting standard per se. Any periodic amendments to the GAAP prompt the issuance of a new SORP, which supersedes the existing one.

The registered charities are required to maintain accounting records, prepare and submit financial statements and annual report (contents of which are not the focus of this study). The charities are obligated to submit their financial statements and annual report within 10 months of their financial year-end. In addition, generally they prepare various narrative reports for funders, trustees and the Charity Commission to assess the financial position and performance. All registered charities must submit a trustees' annual report. This is an important document for trustees to communicate the relevant financial and non-financial information to the interested parties. The details in the trustees' report are expected to vary depending on the complexity and types of operations of a particular charity.

1.5.1 Statement of financial activities (SoFA)

The statement of financial activities (hereafter, SoFA) is the charities' comparable statement of for-profit organisations' income statement. The SoFA provides an analysis of a charity's income and expenditure and movements within and between various fund types in a reporting period. Appendix 1.1 shows a typical template of SoFA. Below, I outline the different parts within the SoFA including charity income

classifications, as well as expense classifications and cost allocations. I also discuss restricted and unrestricted funds.

1.5.1.2 SoFA - Charity Income classifications

Charities receive their income from a whole host of sources. Most charities are funded by public money through donations, or trading via charity shops or sale of merchandise e.g., McMillan Cancer Support receives a large portion of its income from legacies and public donations, and also generates a sizeable share of its income from trading merchandise⁷. Likewise, British Heart Foundation and Cancer Research UK draw a significant portion of their income from fundraising by reaching out for legacies and donations by public.

Other charities operate more like businesses where they charge their beneficiaries for their services or receive government grants in exchange of their services for public benefit e.g. The Air Ambulance Service receives a specific amount from the central government but also receives income from other charitable trusts or foundation charities⁸.

In exchange for services in those areas where the government is unable to directly make an impact, the government funds a large number of charities. For example, Shelter charity secure government contracts in exchange for its services providing housing advice to people facing homelessness⁹.

Then there are charity shops as a well-known medium by mostly established and large charities. There are currently 11,200 charity shops in the UK and Northern Ireland. The wealth generated through these charity shops is generated in three ways, income from donating, buying, and volunteering by public¹⁰.

Charity income can be classified into 1) charitable activities income, 2) fundraising income, 3) income from trading activities, and 4) investment income. Charitable activities income includes income from contractual arrangements for supply of goods

⁷ <https://www.macmillan.org.uk/about-us/what-we-do/our-annual-report-and-accounts>

⁸ <https://www.airambulancesuk.org/wp-content/uploads/2019/12/Association-of-Air-Ambulances-Charity-Ltd-2018-BDO-Signed.pdf>

⁹ https://england.shelter.org.uk/what_we_do/how_we_spend_your_money

¹⁰ <https://www.charityretail.org.uk/>

or services and performance-related grants associated with the provision of specific goods or services by the charity.

Fundraising income includes income from donations and legacies through a gift made to it voluntarily. This is seen as a free income, which is not necessarily in exchange of a particular service like in the case of charitable activities income. Such donations or legacies may form part of unrestricted, restricted or endowment funds.

Income from trading activities are in order to raise funds for the charity and income from fundraising events. This income is received in exchange for supplying goods and services for raising funds. It is not the kind of services or goods that are supplied as the main operation of the charity as is the case for charitable activities income. Income from other trading activities is for a typically trading type activity e.g. a museum's shop selling souvenirs can be classified as trading income but the income received from foundation charities, donors or supporters is most likely going to fall within the income from donations or charitable activities categories.

Charities holding large amounts of bequest assets in the form of endowment are likely to make investments and the income generated from such investment in the form of dividends, interest, or investment property income are another type of income classified as investment income.

1.5.1.3 SoFA - Charity expense classifications

Charity expenses can be classified into 1) charitable activities expenses, 2) fundraising expenses, 3) other expenses. The charitable activities expenses comprise all costs associated with undertaking activities that further the charitable 'objects' for which a charity exists. Most of these costs are direct costs in fulfilling the charitable mission but can also have a share of support costs. Charitable expenses comprise costs in providing goods and services or providing grants to other charities that further the charitable objectives of the charity.

Fundraising expenses include the expenses in raising funds for its charitable purposes. The extant literature, cited in this thesis explains at length that this is a relatively less desirable expense category for charity funders as its high levels could point to low efficiency. Typically these include those for organising fundraising events and other activities that cannot be directly associated with charitable expenses.

All expenses that do not fall in either the charitable activities or fundraising expenses categories are classified as other expenditures.

1.5.1.4 Cost allocations in SoFA

There are several costs that are shared across activities e.g. administration, accounting, information technology, governance costs and other support functions. Such costs must be apportioned across the activities on appropriate bases. There is subjectivity involved in this process and both my qualitative and quantitative studies look at the practice of misallocation through expense misclassification.

There are two primary classes of funds, unrestricted and restricted. A charity is free to spend the unrestricted funds for any charitable purposes of a charity, contained in the “objects” of the charity. The restricted funds can only be used for a specific charitable purpose as stipulated by the funder.

1.5.2 Unrestricted and restricted funds

Charity reporting in the SoFA differs from financial reporting in the income statement in one major way. In addition to presenting income and expense items vertically, it presents columns that represent different sources of funds. These include ‘Unrestricted funds’ and ‘Restricted funds’ (see Appendix 1.1). Some charities will also include a column for endowment funds, which is part of the restricted funds.

Unrestricted funds are those that are not restricted to be used for a particular purpose. Trustees of a charity choose during the reporting period to set aside a part of the unrestricted funds to be used for a particular future project or commitment. By earmarking funds in this way, the trustees set up a designated fund that remains part of the unrestricted funds of the charity.

We note that a large number of charity appeals made for raising funds ranging from famine to Coronavirus related needs are in the form of ‘Restricted funds’. All amounts received for such purpose must be spent for the promoted cause. That is a typical example of funds that should be earmarked as restricted for the specific cause. Similarly, restricted funds also include funds held by specific trusts under charity law. The funder declares these trusts at the time of donation. I take a keen interest in the

proper accounting of these funds and see some as subjective, hence a possibility of their misclassification exists.

There are two types of restricted funds: the restricted income funds and endowment funds. Restricted income funds are required to be spent within a reasonable period after the donation for one of the charitable “objects” as notified to the Charity Commission at the time of charity registration.

A restricted endowment fund could be in the form of a non-current asset held in the trust or an amount which the donor obliges the charity to invest in acquiring assets from the endowment, to fulfil the charitable purposes. The income from such investment can be utilised for the stipulated purposes but the asset itself cannot be used up like income.

When a charity has not been granted the discretion of turning the capital into income, such restricted endowment fund is termed ‘permanent endowment fund’. The fund that provides the trustees with the discretion to turn funds into income either partially or fully is called ‘expendable endowment’. Expendable endowment does not obligate a charity to necessarily spend as opposed to income funds. However, they have to provide details of all income, gains, expenses and losses recognised for a particular reporting period, and analyse this by the type of activities carried out to show how resources have furthered the charitable aims. It also presents a breakdown of the change in the charity’s funds for that period.

All charities that prepare accounts on an accrual basis must prepare a SoFA for each reporting period and include this in their annual accounts. The SoFA should analyse the key activities carried out. Activity lines should show the split between unrestricted and restricted income (and endowment funds, if relevant). Figure 1.1 shows the breakdown of the types of funds within a charity into the sub-groups discussed above.

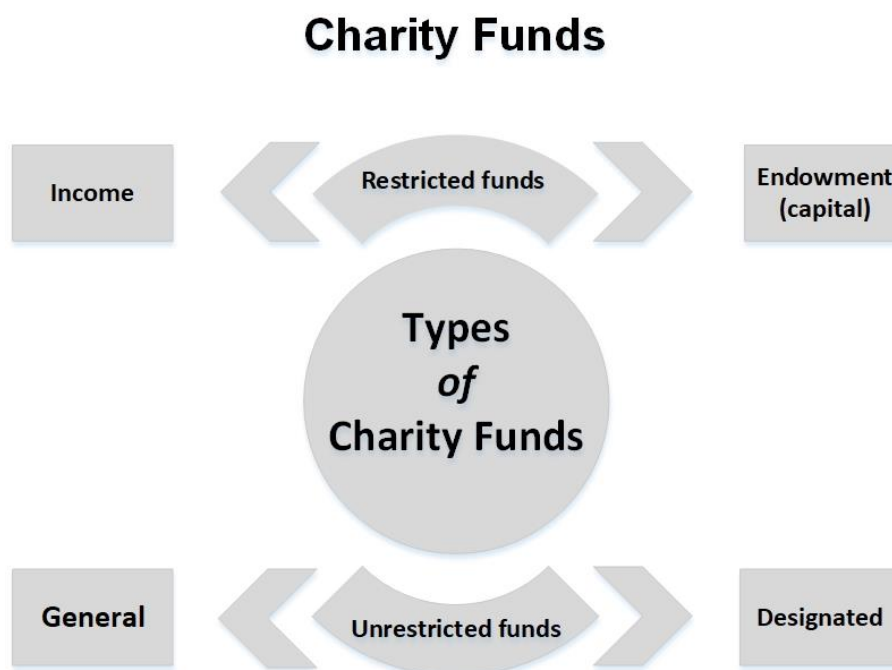


Figure 1.1: Sub-grouping of types of funds of a charity

1.5.3 The Statement of Financial Position – The Balance Sheet

The Statement of Financial Position or more commonly known as the Balance Sheet is a snapshot of an organisation's financial position at one given moment.

According to Section 4 of FRS 102¹¹ - The Financial Reporting Standard applicable in the UK and Republic of Ireland, the statement of financial position presents an entity's assets, liabilities and equity at the end of the reporting period. A charity is not set up with equity, as would be in the case of for-profit firms. Other than its assets and liabilities, a charity's balance sheet comprises the charity reserves. The charity reserves are also referred to as funds, which are equal to the net assets. As discussed above, the charity funds comprise unrestricted, endowment and restricted funds. It is, however, important to note that the term reserve should technically refer only to the unrestricted funds. In the strict sense, the restricted funds cannot be viewed as reserves as their use is not entirely in a charity's control.

¹¹ [https://www.frc.org.uk/getattachment/69f7d814-c806-4ccc-b451-aba50d6e8de2/FRS-102-FRS-applicable-in-the-UK-and-Republic-of-Ireland-\(March-2018\).pdf](https://www.frc.org.uk/getattachment/69f7d814-c806-4ccc-b451-aba50d6e8de2/FRS-102-FRS-applicable-in-the-UK-and-Republic-of-Ireland-(March-2018).pdf)

1.6 Motives for earnings management

There has been a considerable body of literature studying possible motivations for managers in engaging in the practice of earnings management including stakeholder use of information-processing heuristics and prospect theory (e.g. Dechow and Sloan, 1991; Burgstahler and Dichev, 1997). The purpose of earnings management is to manipulate reported earnings either upwards or downwards to meet specific targets such as meeting earnings benchmarks (Degeorge et al., 1999; Dechow and Dichev, 2002), increasing share prices (e.g. Schipper, 1989) meeting performance-based compensation (e.g., Balsam, 1998; Cheng and Warfield, 2005; Bergstresser and Philippon, 2006) and to avoid debt covenant violations (e.g., DeFond and Jiambalvo, 1994; Sweeney, 1994; Jaggi and Lee, 2002). Extant literature is extensive on this topic and has addressed this from various angles. In order to mitigate against erratic share performance that investors would be most uneasy about, managers face a constant pressure to maintain a smooth level of earnings through a practice, commonly referred to as 'income smoothing'; it is another common incentive for managing earnings because erratic earnings are interpreted as a sign of increased riskiness of the firm, therefore, investors expect a higher return, exerting in some cases, undue pressure on the management. Managers in essence borrow earnings from future to compensate for the current poor earnings whereas they save current earnings for the future where future earnings are anticipated to be poor. Economic actions to smooth earnings can sometimes sacrifice long-term value. (e.g. Graham and Harvey, 2005; Tucker and Zarowin, 2006; Defond and Park, 1997).

The majority of the studies have been undertaken on organisations that show signs of earnings management yet staying within the bounds of relevant accounting standards and not breaching any particular laws; however, there have been some studies which have focused on the cases where Generally Accepted Accounting Principles (GAAP) was violated such as in the study by Beneish (1999) whereby he investigated the overstatement of earnings by employing means that violated relevant accounting standards and had a higher likelihood of insider trading than other firms.

Healy and Wahlen (1999) in light of their review of the literature allude to various incentives for managing earnings. Stock analysis extensively uses accounting information to value stocks and therefore managers may be inclined to influence short-term stock price performance. Similarly, accounting data is used to monitor and

regulate the contracts between the firm and its many stakeholders. This includes various explicit and implicit management compensation contracts that are used to align the incentives of management and external stakeholders. Likewise, compensation contracts can lead to the practice of earnings management to increase bonus awards and improve job security. Likewise, earnings management has been studied in some cases as a tool to mitigate potential violation of debt covenants. Also, empirical research has provided evidence that industry-specific regulation and anti-trust regulation have also been the reasons for managing earnings (Healy and Wahlen, 1999).

1.7 Alternative techniques of earnings management

Although the focus of this study is to contribute to the earnings management literature in the UK charities' setting, in the absence of much literature in this setting it would be fitting to start with the well-cited prior literature on for-profit firms which finds evidence that managers manipulate reported earnings upward to meet performance-based compensation (e.g., Cheng and Warfield, 2005; Bergstresser and Philippon, 2006) and to avoid debt covenant violations (e.g., DeFond and Jiambalvo, 1994; Sweeney, 1994). Schipper (1989) lays culpability on the pursuit of private gain that leads to earnings management.

Roychowdhury (2006) points out that on the one hand accounting choices i.e. accrual-based earnings management occur at the end of the financial year, whilst on the other, real cash flow choices i.e. real activities-based earnings management, occur throughout the year with direct consequences for current and future cash flows. Findings by Roychowdhury (2006) and by succeeding researchers (e.g. Ewert and Wagenhofer, 2005; Cohen et al., 2008; Cohen and Zarowin, 2010; Gunny, 2010; Zang, 2012) are consistent with the previous research that managers manage earnings upwards to avoid reporting losses.

In this section I introduce the three most common techniques that have been identified by the extant literature in managing earnings, namely Real Activities Earnings Management (REM), Accruals based Earnings Management (AEM) and Classification Shifting.

1.7.1 Real Activities Earnings Management (REM)

Real earnings management can be achieved by timing investment or financing decisions to influence earnings to their subset (Schipper, 1989). This is a comparatively new area in earnings management research. Research and Development costs were the focus of some of the earlier researchers in this stream of earnings management. (Baber et al. 1991; Dechow and Sloan 1991; Bushee 1998). Graham et al. (2005) through their interviews with executives identified the following areas as potentially used to manipulate earnings: hiring, Research and Development (R&D), advertising, travel, maintenance, and capital expenditures to avoid depreciation expense. This was taken further by Roychowdhury (2006) who identified some further income statement accounts of interest in this regard. Firms of interest that show earnings just towards the right of breakeven point i.e. with small profits appear to have given generous price discounts to their customers in pursuit of increasing revenue. Similarly, another tool employed by some managers of firms with the noted low earning levels includes overproduction of inventory to absorb fixed costs by more units which leads to lower cost of sales. Gunny (2010) report that REM is not opportunistic, but consistent with the firm attaining current-period benefits that allow the firm to perform better in the future or signalling by becoming informative about future earnings of the firm. Further research finds that managers sell assets to make a profit on disposal when the incentive is to show earnings just above the zero benchmarks; similarly, if the earnings are above the target level then the managers avoid selling assets especially when such disposals may lead to profits (Bartov, 1993; Hermann et al. 2003, Eldenburg, 2011). As discussed earlier, earnings management behaviour has been studied far less in nonprofit entities; even less so in the UK setting and it has been limited primarily to the nonprofit hospital setting. Specifically, the findings show similarities between for-profit and nonprofit entities, in the earnings management behaviour (Leone and Van Horn, 2005; Ballantine, 2007; Eldenburg, 2011).

Data limitations have meant that the research in real earnings management has been limited to a handful of expense types (Baber et al. 1991; Dechow and Sloan 1991; Bushee 1998; Roychowdhury 2006; Cohen et al. 2008; Cohen et al. 2010, Eldenburg 2011). I will be utilising my dataset to study whether the 12 sub-sectors of charities engage in real earnings management. In the first study, I find that incentives for manipulating in a charity are similar to those of the for-profit firms as far as increasing

the income when earnings are expected to fall below zero i.e. showing a deficit. This is more commonly referred to as net outgoing resources in charity sector fund accounting.

1.7.2 Accruals based Earnings Management (AEM)

Earnings represent the difference between income and expenses; where both income and expenses have two components i.e. cash receipts and payments and income earned and expenses incurred without the relevant cash flow during the period. The latter is referred to as accruals. Total accruals can be prone to management judgements and estimates about cash flows in the future to make accounting earnings that better reflect a firm's underlying economic performance and position. The extant literature divides accruals into two components namely discretionary accruals and non-discretionary accruals. Non-discretionary accruals refer to the accounting adjustments to the firm's cash flow as required by relevant accounting standards and accepted convention. Researchers are more interested in the discretionary accruals element. As discretionary accruals cannot be observed directly, various proxies have been suggested in the existing literature. For example, Healy (1985) uses total accruals and DeAngelo (1986) uses the change in total accruals as a proxy for discretionary accruals. The Jones (1991) and modified Jones models (Dechow *et al.* 1995) employ more sophisticated approaches in earnings management estimations. These are employed by most academic researchers in the context of earnings management (e.g. DeFond and Jiambalvo, 1994; Dechow *et al.*, 1995; Beneish, 1997; Kothari *et al.*, 2001).

Informed by stakeholder theory and resource dependence theory, this paper investigates whether UK charities are engaged in earnings management practices.

This study is similar to Nguyen and Soobaroyen (2019) to the extent that it also investigates whether UK charities are involved in earnings management. This is where the similarities end. This study utilises both qualitative and quantitative techniques in its attempt to answer various related questions.

Nguyen and Soobaroyen (2019) only investigate earnings management using quantitative method, whereas this study in addition to utilising quantitative method for investigating the occurrence of earnings management includes interviews with finance

directors of large UK charities, and only a small part of that study investigates the occurrence of earnings management in UK charities.

My thesis studies earnings management using both real and accruals-based earnings management. Nguyen and Soobaroyen (2019) only investigate accruals-based earnings management. The methodology is similar in estimating normal level of accruals but the sample selection process is different.

The second study in this thesis utilises the largest available sample of over 103,000 audited charity years, covering a period of 12 years (2007-2018). This is a very comprehensive study in comparison with a sample of 1414 charities over a five-year period (2008–2012) used by Nguyen and Soobaroyen (2019).

The empirical results in Nguyen and Soobaroyen (2019), study the impact of leverage on earnings management behaviour by charities. This thesis studies the sector in much deeper level by dividing charities between more service-oriented, with a larger donor-beneficiary distance and charitable nonprofits. Similarly, this study investigates the impact of donor sophistication on management's willingness for earnings management, for which purpose it divides charities on the basis of restricted donations. It also studies the moderating effect of large endowment funds on earnings management behaviour using both real and accruals-based earnings management techniques. This study finds that charities that are funded by funders that are more sophisticated tend to manipulate less towards a target range, hence confirming that they are aware that such practice would be counterproductive to their future donations. I find that the accruals-based manipulation is exacerbated by more service-oriented charities (i.e. nonprofits with higher than median programme revenue). On the contrary, real activities management is higher in more charitable nonprofits (i.e. those with lower than median programme revenue). Therefore, pressure to manipulate earnings is more likely through the costlier form of earnings management i.e. real activities earnings management.

These findings in the second study are significantly different from the work carried out by Nguyen and Soobaroyen (2019). The third study answer a very different question, hence there are no similarities with Nguyen and Soobaroyen (2019).

1.7.3 Classification shifting earnings management

Technically speaking this is not an “earnings” management technique; rather it merely shifts the accounting numbers within the income statement. This method is comparatively newer in the earnings management literature compared to the other two. This technique of earnings management does not affect the bottom line figure i.e. the profit/loss in the income statement. The seminal paper on this method of earnings management by McVay (2006) provides empirical evidence of classification shifting between core earnings and special items. This may seem trivial to an unsuspecting eye since it does not affect the final figure in the income statement that is available to investors; however, through closer scrutiny it becomes evident that core items are a regular and consistent year-on-year expense, whereas special items are nonrecurring. Therefore a higher earnings figure from core activities is far more desirable for investors than nonrecurring special items, as they are a better indicator of earnings sustainability (unsustainability) than what a figure such as net earnings after special items may represent. McVay (2006) shows that managers tend to shift the figures between core and special items in such a way that core earnings receive an income increasing treatment whereas special items would be at the receiving end of an income decreasing treatment. As mentioned above, this area is still relatively new and to build a theory around it needs further research employing various methods. Abernathy et al. (2014) suggest that a large auditor and high level of institutional ownership may be deterrents against classification shifting. The for-profit literature also points to the substitution effect of classification shifting when the ability of managers to manipulate accruals appears to be constrained (Fan et al., 2010; Abernathy et al., 2014). Similarly, UK firms are more likely to engage in classification shifting rather than in accruals management to avoid negative earnings surprises (Athanasakou et al., 2019). The nonprofit setting is different and there is no such thing as core earnings; hence it is not conceivable that the bottom line figure will be manipulated through a comparison of classification shifting in nonprofits. I do however use the broad concept and methodology with variation in my expense classification study (third study).

1.8 Empirical evidence of earnings management

The earnings management phenomenon aims to manipulate reported earnings either upwards or downwards to meet various targets in light of the incentives alluded to in the earlier discussion; such as but not limited to meeting earnings benchmarks

(Degeorge et al., 1999; Dechow and Dichev, 2002), improving share prices (Schipper, 1989). Motivations and consequences of earnings management activities vary (e.g., Dechow and Sloan, 1991; Jones, 1991) depending on the individual circumstances and setting. Managers aim at important earnings targets by employing both real earnings management (e.g. Graham et al. 2005; Roychowdhury 2006; Gunny 2010) and accruals-based earnings management (e.g. Dechow et al. 1995; Kothari et al. 2005). Similarly, managers have been reported to have purposefully misclassified items within the income statements to overstate core earnings (e.g. McVay 2006; Fan, 2010; Athanasakou et al., 2014). The target of interest in the eyes of some stakeholders is typically not just the total earnings but, consistency in core earnings.

Evidence, in the US in particular, suggests firms close to an important earnings benchmark are more likely to engage in earnings management (Burgstahler and Dichev 1997; Degeorge et al. 1999). The bulk of research on earnings management from the studies in the US present extensive evidence that managers employ a variety of earnings management methods such as REM, AEM and classification shifting, in order to meet or beat their targets,

Earnings management activities can be implemented without violating GAAP, employing either accounting choices or real activities choices (Dechow and Skinner, 2000). Earnings management must not be confused with fraudulent accounting as fraud is illegal and leads to breaking the law. Figure 1.2 depicts a wide spectrum of prudent and fraudulent accounting choices, presenting examples of the use of accounting vs. real cash flow choices.

	Accounting Choices	Real Cash Flow Choices
Conservative Accounting	Within GAAP Overly aggressive recognition of provision or reserves. Overvaulting of acquired in-process R&D in purchases acquisitions. Overstatement of restructuring charges and asset write-offs.	Delaying sales. Accelerating R&D or advertising expenditures.
Neutral Accounting	Earnings that result from a neutral operation of the process	
Aggressing Accounting	Understatement of the provision for bad debts. Drawing down provisions or reserves in an overly aggressive manner.	Postponing R&D or advertising expenditure. Accelerating sales.
Fraudulent Accounting	Violate GAAP Recording sales before they are "realisable". Recording fictitious sales. Backdating sales invoices. Overstating inventory by recording fictitious inventory.	

Adapted from Dechow and Skinner, 2000 P.239

Figure 1.2: Earnings management versus fraudulent accounting

The regulatory body in the UK which is closest to the Securities and Exchange Commission (SEC) in its jurisdiction and remit is arguably the Financial Conduct Authority (FCA). In response to the concerns that Financial Reporting Council (FRC) in the UK has been very slow in investigating financial reporting misconduct, and that it is too lenient and its board too cosy with the very industry that it is meant to supervise, more powers have been handed to FCA ("Corporate scandals prompt shake-up at UK accounting watchdog", 2020)¹².

1.9 Financial misreporting in charities

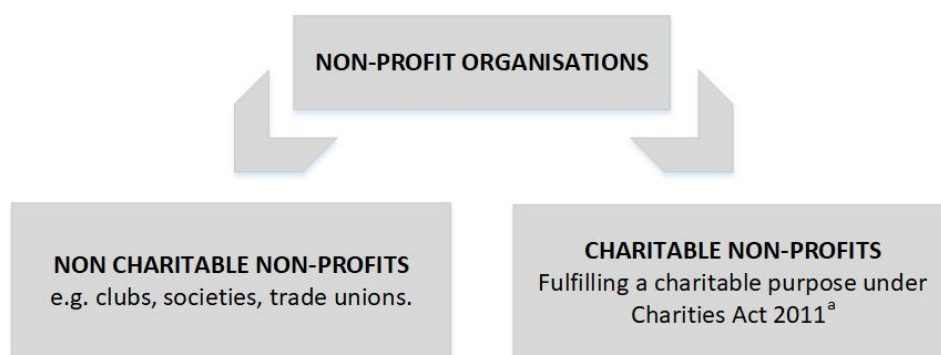
Burks et al., 2015 report that charities report 60 percent more errors than corporations traded publicly, and almost double that of a similar-sized corporation.

¹² <https://www.ft.com/content/0abe6718-47ed-11ea-ae2-9ddbdc86190d>

For-profit organisations aim to meet or beat certain external benchmarks such as analysts' forecasts, therefore securing the stock market performance; however, a charity is under pressure of heavy scrutiny from various stakeholders such as the regulator (Charity Commission) and funders. A charity, in general, is expected to avoid a breakeven point and therefore would attempt to exercise income increasing earnings management, possibly real activities-based earnings management (Eldenburg, 2011); similarly, a very high earnings level will also attract suspicions and questions from funders and would risk lower funding.

In nonprofit organisations, performance indicators play an important role because the primary purpose for a nonprofit's existence is not financial; its objectives are characteristically subjective and nonfinancial, therefore the progress in relation to precise objectives is difficult to quantify. According to Hofmann and McSwain (2013), accounting research on nonprofit entities focuses on either governmental or non-governmental units. The scope of this research is limited to nongovernmental organisations which are registered with the Charity Commission as charitable entities. Hence strictly speaking not all nonprofits are charities but all charities are nonprofits. The following diagram (Figure 1.3) explains the place of charities within all organisations.

Charitable Sector Context



^aFalling within 13 descriptions of purposes for the public benefit. However, falling within the listed categories does not grant an automatic right for a charitable status, rather an organisation must fulfil the public benefit test with a 'charitable purpose.'

<https://www.gov.uk/government/publications/charitable-purposes/charitable-purposes>

Figure 1.3: Charitable sector context

There may not be a comprehensive definition of nonprofit organisations, but the sector covers the distinctive social space not covered entirely by the capital markets or the state. Similar to the US, the UK has a clear concept of the nonprofit sector (referred to as charity sector) but due to flexibility with a stronger hold of the “common law” tradition, the legal boundaries of the sector are far more complicated than in the US setting (Salamon and Anheier, 1997). It is therefore difficult for funders to fully comprehend the intricacies and subtleties that separate the classifications within the sector. The social science research within the nonprofit sector has focused on the registered charities (Posnett, 1987) which are formally registered by the UK Charity Commission and thereby accorded the protection of the Crown, the Courts, and the Charity Commission. Currently, the entire sector has an income in excess of £77bn, own assets over £81bn and have over £160bn in long- and short-term investments. It is an important sector with over 1.1 million employees and a further 4.2 million volunteers.¹³

Nonprofit entities are different from for-profit entities in ways that can affect reporting incentives and constraints. The main reason is that the objectives of a nonprofit organisation are not to make a profit. Although nonprofits have a different set of stakeholders with differing interests, research shows that nonprofits also have both motives and opportunities to misreport financial information in order to mislead stakeholders or influence contractual outcomes (Hofmann and McSwain, 2013). There has been evidence of incentives to manage earnings in the health sector in the US (and in some other countries). Potential donors want to see their contributions spent in meaningful, effective, and efficient ways, and creditors want to be able to assess credit risk and return (Parsons, 2003). Information asymmetry is greater in nonprofits compared to for-profit organisations. Effectively, there are two principals i.e. the donor and the beneficiary in case of nonprofits (Kitching, 2009). Since there are various income sources for charities such as from government grants, government contracts, corporate donations, individual donations, legacy income, endowments etc..., each charity's main source of funders would have a bearing on its motives to manipulate financial reporting numbers; these motives are expected to be wide-ranging such as in pursuit of avoidance of a big surplus as there are political costs associated with a surplus which implies that the nonprofit is not fulfilling its charitable mission (Leone

¹³ <http://apps.charitycommission.gov.uk/Showcharity/RegisterOfCharities/SectorData/SectorOverview.aspx>

and Van Horn, 2005; Jones and Roberts, 2006). This could potentially put donors off from making donations in the future. A plausible explanation could be that a surplus can lead a donor into believing that the charity does not need large donations in the next period. They may assume that the charity can meet its future costs by using its carried-forward surpluses. Similarly, the extant literature provides evidence that donations are positively associated with the programme ratio, i.e. the ratio between the expenses on charitable expenses to the total expenses, which implies an incentive to misclassify expenses (Tinkelman, 1998, 1999; Gordon et al., 2009; Okten and Weisbrod, 2000).

Steinberg (1986) looks at two types of charities i.e. budget maximisers that maximise the incoming resources of the charities and service maximisers that attempt to maximise the residual of resources to be employed for the services. This can be attained by minimising the fundraising and administrative costs so that the available resources to spend on charitable costs or programme expenses are maximised in pursuit of the charities' objectives. Posnett and Sandler (1989) found UK charities to be "net revenue maximisers" i.e. they are in pursuit of maximising the available surplus for charitable activities expense. Khanna et al. (1995) in their study of the UK charities report that where health and overseas charities are net revenue maximisers, religious charities maximise total revenues, whereas social welfare charities were found to fundraise short of the point at which net revenues are maximised.

Potential donors are interested in assuring that nonprofits will use their contributions in meaningful, effective, and efficient ways, and creditors are interested in being able to assess credit risk and return (Parsons, 2003). Managers have understandably better information regarding the firm's financial position and performance than the outside users of the financial information. This creates financial information asymmetry and naturally provides management with the incentive to indulge in financial disclosure management. Since there are two principals, namely donors and beneficiaries in the case of a nonprofit, therefore information asymmetry is more likely than in corporations (Kitching, 2009). Donors effectively purchase the benefit such as humanitarian aid, whereas a beneficiary acquires benefit from such aid.

Information asymmetry in the nonprofit sector is worsened because all stakeholders have access to differing quantity and quality of financial information. A charity's main

focus from its donors' perspective is expected to be on maximising programme expenditure for which donors fund them. Programme expenditure is commonly referred to as charitable activities in the UK and it relates to all those costs which are directly associated with delivering the core services of a charity.

To make stewardship decisions, the board of trustees use information including accounting information (Hofmann and McSwain, 2013); similarly, accounting information is also needed for other implicit and explicit contracts with creditors, managers, and other resource providers. Regulations, governance, information asymmetry and agency problems provide motives and opportunities for financial disclosure management (Hofmann and McSwain, 2013). For a nonprofit organisation, there is no apparent claim to the bottom line figure as donors do not expect a monetary benefit out of their contributions. Therefore a surplus figure could potentially cause political costs, that the authorities, press and public may view suspiciously that the charity is not fulfilling its mission and objectives (Leone and Van Horn, 2005; Jones and Roberts, 2006).

According to Hansmann (1996), agency problems are exacerbated when donors do not effectively monitor the performance of the managers. Indeed, in such situations, managers may carry out their duties inefficiently and they are likely to expend the resources of the organisation in the activities that are "peripheral" to the main objects of the organisation (Krishnan et al., 2006).

There is a significant political cost associated with showing net incoming resources or surplus in the statement of financial activities (SoFA). This pressure has been intensified by some media pressure on some of the UK's richest charities such as Lloyd's Register Foundation, British Heart Foundation and Age UK that spend as low as less than half of their income on their charitable activities (or programme expenses). This could lead to a continued pressure on charities to sustain programme ratio or reduce fundraising expenses and other indicators to avoid political costs in the same vein as Leone and Van Horn (2005) and Jones and Roberts (2006).

Charities are expected to be subject to unfavourable press attention in case they are not seen to be fulfilling the philanthropic objectives that they exist for. For example, the level of charitable expenses in comparison to the total expenses has been an area of specific attention for researchers. If their programme ratio considerably declines or

is lower than expected levels, or if the programme ratio falls below the watchdog benchmarks then that may result in increased scrutiny (Barrett 1999).

1.10 Motives for financial misreporting in charities

This section presents some of the motivations that managers of the nonprofit sector organisations have in misreporting their bottom line figures in their financial statements. Figure 1.4 succinctly sets the scene of the costs to a charity for showing high profits (surpluses) or losses (deficits), therefore motivating managers to misreport their bottom line figures to avoid such costs. The following sections will discuss the motivations from the perspectives of various other researchers in this area of literature.

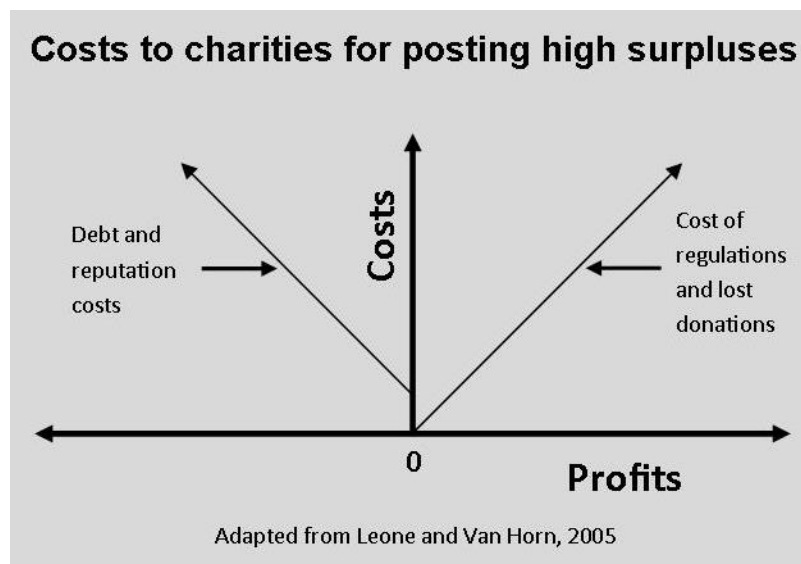


Figure 1.4: Costs to charities for posting high surpluses or deficits

1.10.1 Retention and perpetuation of funding

It has been established by various academic researchers that nonprofit executives believe that the efficient use of resources attracts and retains funding. That is achieved by keeping administrative costs low (Parsons et al., 2017). Contracts with third parties are also influenced by the bottom line figures and may lead to negotiations for price concessions. Cost-shifting by hospital has been noted to maximize reimbursements from third-party payers. Eldenburg and Soderstrom (1996) and Eldenburg and Kallapur (1997) find evidence that both for-profit and nonprofit hospitals manage their

patient mix, cost allocations, and budget estimates of patient volume and costs to increase revenues and maximize cash flows. Scandals related to inefficiency of use of funding include that of the Suicide Bereavement Charity Console whose founder squandered charity funds on salaries, care and holidays. Similarly, debacles of charities such as Kids Company have added to the public scrutiny of the charities' finances and make financial statements quite relevant as a signal to the funders of its legitimacy. Trussel (2003, P616) states that "*Managers of nonprofit organizations may have incentives to manipulate their reported program-spending ratios because donors use them in determining contribution decisions*".

The extant literature has extensively provided empirical evidence that donations are positively associated with the programme ratio (e.g. Weisbrod and Dominguez, 1986; Posnett and Sandler 1989; Callen 1994; Tinkelman, 1999; Baber et al. 2001; Yetman and Yetman 2003). Predominantly in the US and in the UK, a considerable amount of literature has concluded that donors of a nonprofit firm use accounting information in forming their decisions for allocating their donations. A better programme ratio can be seen as a tool to improving the chances for future donations, therefore providing a reason for the management to influence classification shifting in favour of a high programme ratio or in other words low fundraising or governance costs concerning the total expenses.

1.10.2 Tax exemption

Those nonprofit organisations that are engaged in taxable activities have a motive to shift cost allocations from charitable to taxable operations in order to reduce their tax bill. This motive has been heavily studied in the US (Sansing, 1998; Jegers, 2010). Nonprofits also face pressures from donors and the general public who seek reassurance that the nonprofit receiving tax is working effectively and ethically without wasting resources (Hoefer, 2000; Cairns et al., 2005). Nonprofit managers may attempt to mislead the regulator in the US, i.e. the Internal Revenue Service (IRS) regarding their organisation's tax-exempt status to justify its position as a nonprofit.

Leone and Van Horn (2005) state that tax authorities monitor nonprofit hospitals' profitability in part to assess whether they should retain their tax-exempt status. Within the UK charity sector, there are no obvious tax reasons to manage earnings as long

as all funds are utilised for the charitable purposes. Lewis (2009) counts various tax-exempt areas in light of the comprehensive list provided by the UK government on its charities and trading page. Profits from primary charitable purposes or activities, rental income from land and buildings, income from bank interest, dividend through investments, certain fundraising events, gifts and the sale of donated goods are exempt from corporation tax, even though many UK charities are also registered companies by limited guarantee¹⁴ or charitable incorporated organisations. If these gains are entirely used for charitable purposes, then they are exempt from capital gains tax as well.

1.10.3 Managers' career aspirations

Management of an organisation would want to be running an organisation as a going concern. There is a degree of personal esteem attached to the performance of an organisation that one manages. Hospital CEOs are often evaluated on financial performance (Brickley and Van Horn, 2002); if losses are reported then it might negatively affect compensation, reputation, and career mobility. I would expect this to be consistent with most large charity organisations in the UK.

1.10.4 Debt covenants

As charities do not issue equity therefore there are only two sources for raising finance i.e. through increased revenue or by issuing debt. A *“significant number of nonprofits have significant amounts of debt”* on their balance sheets (Yetman, 2007; p248). Trueman and Titman (1988) provide evidence that the cost of debt can be reduced by reducing inconsistency or variability of earnings. This would lead me to infer that the management will have incentives to manage earnings around a certain benchmark, which is more likely to be around zero in light of the constraints with high surpluses or deficits. Managers may have the logic for doing so as it would reduce the cost of debt and those saved costs could be best utilised in providing services to the beneficiaries.

A charity is seen as either having exhausted the activities that it once stood for or is unable to ascertain activities that would be required to further the objects of the charity.

¹⁴ a company limited by guarantee is set up with special charitable articles, and is registered both at Companies House (as a company) and with the Charity Commission as a charity in its own right.

1.11 Summary

This chapter presents the research gap, contributions of the study and an introduction to the charitable sector. It also presents an overview of charity accounting, prior literature on financial misreporting in UK charitable organisations, and an introduction to the three studies in this thesis. The importance of the sector is significant and its impact on our lives is immense. The charity accounts are different from for-profit financial statements and hence are less commonly recognisable to an untrained eye. The extant literature, mainly in the US nonprofit setting discusses financial reporting quality. Evidence in the current literature suggests that nonprofits misreport their bottom-line figure using accruals-based and real earnings management techniques. Charities are understood to misreport their fundraising and charitable activities expenses to improve their operating ratios.

Better scrutiny of the charitable sector is important given the substantial public donations and volunteering, as well as the large government support from taxpayers' money. Furthermore, the growing lack of trust puts pressure on charities to present their financial statements in certain ways. The financial reporting quality literature in the nonprofit sector is scant and particularly silent using qualitative research methods. This first chapter summarises the findings from the current literature of the motivations for financial misreporting. The chapter introduces the three studies of the thesis that contribute to an area for academic and practical significance. The thesis presents a qualitative study using semi-structured interviews, a technique that has been absent for understanding motivations for financial reporting manipulation, both in the for-profit and nonprofit sector. This thesis also uses the largest dataset in UK-based academic studies. This is also the first study that investigates the impact of funder sophistication and donor-beneficiary separation on charity managers' willingness to misreport in their financial statements.

Appendix 1.1: Statement of Financial Position (SoFA)

	Unrestricted funds	Restricted funds	Endowment funds	Total funds	Prior period Total funds
	£	£	£	£	£
Income and endowments from:					
Donations and legacies					
Charitable activities					
Other trading activities					
Investments					
Other					
Total					
Expenditure on:					
Raising funds					
Charitable activities					
Other					
Total					
Net gains/(losses) on investments					
Net income/(expenditure)					
Transfers between funds					
Other recognised gains/(losses):					
Gains/(losses) on revaluation of fixed assets					
Actuarial gains/(losses) on defined benefit pension schemes					
Other gains/(losses)					
Net movement in funds					
Reconciliation of funds:					
Total funds brought forward					
Total funds carried forward					

CHARITIES SORP (FRS 102) ¹⁵

¹⁵https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/870619/charities-sorp-frs102-2019a.pdf

Appendix 1.2: Balance Sheet

Note ref.		Total funds	Prior year funds
		£	£
	Fixed assets:		
	Intangible assets		
	Tangible assets		
	Heritage assets		
	Investments		
	<i>Total fixed assets</i>		
	Current assets:		
	Stocks		
	Debtors		
	Investments		
	Cash at bank and in hand		
	<i>Total current assets</i>		
	Liabilities:		
	Creditors: Amounts falling due within one year		
	<i>Net current assets or liabilities</i>		
	<i>Total assets less current liabilities</i>		
	Creditors: Amounts falling due after more than one year		
	Provisions for liabilities		
	<i>Net asset or liabilities excluding pension asset or liability</i>		
	Defined benefit pension scheme asset or liability		
	Total net assets or liabilities		
	The funds of the charity:		
	Endowment funds		
	Restricted income funds		
	Unrestricted funds		
	Revaluation reserve		
	Pension reserve		
	<i>Total unrestricted funds</i>		
	Total charity funds		

CHARITIES SORP (FRS 102) ¹⁶

¹⁶https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/870619/charities-sorp-frs102-2019a.pdf

Chapter 2: Study on the Motivators of Financial Statement Misreporting in the UK Charity Context

2.1 Introduction

The study aims to explore, from charitable organisations' perspective, the factors that motivate managers to misreport financial statements. The following sections discuss the theoretical background and analysis of interviews conducted to study misreporting of financial statements by charities registered in England and Wales.

This study is limited to those large organisations that are established for charitable purposes as defined by the Charities Act 2011 and registered with the Charity Commission, the regulator of the sector in England and Wales.

The study is motivated by the fall in trust and confidence in charities in recent times.¹⁷ Specifically, the latest scandals surrounding UK charities (e.g. Kids Company's collapse and Age UK's mis-selling to the older generation) have contributed to a plunging of public confidence to its lowest level since it was first measured in 2005.¹⁸ As a consequence, the cash donations to the charities have dropped,¹⁹ something which is a life line for the sector. The main reasons cited for the fall in trust were negative media reports of the sector in general and lack of public trust as to where the money was spent. A third of those whose trust and confidence has decreased, attribute this to general media stories about charities and a further third cite media coverage about how charities spend donations. Likewise, excessive spending on administrative costs such as advertising and wages has been reported as a reason for concern.²⁰ The Scottish Charity Regulator, OSCR, has also reported a decline in confidence albeit less pronounced compared to that in England and Wales.²¹ Add to this the significant reduction in the funding available to the Charity Commission, and the situation becomes a matter of concern for donors and philanthropists. In the

¹⁷ According to a report published in July 2016 which was commissioned by The Charity Commission and conducted by Populus.

¹⁸ (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/532104/Public_trust_and_confidence_in_charities_2016.pdf)

¹⁹ <https://www.theguardian.com/society/2019/may/07/fewer-britons-donate-charities-after-scandals-erode-trust>

²⁰ 15% of the sample from public survey suggested: "Too much money is spent on advertising/wages".
https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/532104/Public_trust_and_confidence_in_charities_2016.pdf

²¹ <https://www.gov.uk/government/news/public-trust-in-charities-has-fallen-reports-charity-commission>
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/532104/Public_trust_and_confidence_in_charities_2016.pdf

absence of sufficient resources, the task of the Regulator may become more difficult in identifying early warning signs.²²

Commenting on the current state of affairs, William Shawcross, Chairman of the Charity Commission, observed *“action is needed to restore public confidence. These results are a call to action for everyone who values public trust in charities.”*²³

Furthermore, a survey conducted by Charity Aid Foundation revealed that nearly one fifth of charities are struggling to survive.²⁴ The main worry for the public, as cited by the head of research at Charity Aid Foundation, is that *‘their hard-earned money is not being well spent’*. Growing cynicism towards the sector can lead to a priori assumption that the managers of the charity may be willing to do all that they can in order to repair the damage and sustain their income. There is a strong likelihood, that to be seen as spending responsibly in the eyes of donors and regulators a charity will consider window-dressing its financial statements. It is true that financial statements are not the only source of information about performance but it is not implausible that the accounting numbers are one of the most effective tools for communicating a charity’s legitimacy to its stakeholders. This study is conducted to find evidence of whether the financial reporting quality of charity organisations registered with the Charity Commission in England and Wales is being compromised.

This study contributes to the scant literature on financial reporting quality amongst charities in various ways. Firstly, it makes a methodological contribution where to my knowledge financial reporting quality has not been studied through in-depth semi-structured interviews. Secondly, this study focuses exclusively on motivations that managers have in manipulating financial statements; again to my knowledge this area has not been given such explicit attention on its own prior to this. Thirdly, vast development in accounting in general and charity accounting in particular over the last decade warrants the need for a fresh understanding of the impact of such changes on managers’ motivations to compromise financial reporting quality. The unprecedented

²² <http://www.bbc.co.uk/news/uk-politics-26036279>

²³ <https://www.gov.uk/government/news/public-trust-in-charities-has-fallen-reports-charity-commission>. Results showing a falling public trust from the research using surveys of a representative sample of over 1,000.

²⁴ <https://www.cafonline.org/about-us/publications/2017-publications/social-landscape-2017>

pressures exerted by COVID-19 are expected to exacerbate income uncertainty²⁵ and could well lead to financial misreporting.

This paper proceeds as follows. Section 2 presents the theoretical framework for financial statements' misreporting and outlines various theories that explain the motivations for financial reporting management in nonprofit settings. I present agency, resource dependency and legitimacy theories as the underpinnings vis-a-vis motivations for financial statements misreporting. However, I recognise that there may be various other theories that can explain motivations for financial statements misreporting in charity sector organisations. Section 3 examines the literature in charity accounting that deals with financial misreporting. Section 4 explains the methodology for this study. Section 5 presents a detailed discussion of interview results with an in-depth analysis of motivations and pressures for manipulation that are faced by charity managers and accountants. This section also develops an understanding of those factors which interact to facilitate financial misreporting. Conclusion of the discussion is presented at the end in section 6 where I also propose further avenues for research in a significantly under-researched area.

2.2 Theoretical framework

In this section, I discuss the theories that underpin incentives to manipulate financial reporting in charities. I briefly present agency, resource dependency and legitimacy theories. In addition, a brief discussion on the "fraud triangle" (Cressey, 1953) is included which is also relevant in understanding potential motivators for managers who choose to perpetuate inappropriate behaviour.

An integrated approach is of increasing relevance in explaining the complexities of charitable activities (Jonsson, 1991; Helmig et al., 2004). In this study, I employ the agency, resource dependency and legitimacy theories, which I believe shed light on the pressures faced by charities vis-à-vis their financial reporting choices. These are discussed below.

²⁵ <https://www.ft.com/content/00362e6f-8854-43dc-bb01-98bf4a396b18>

2.2.1 Agency theory

Agency theory highlights potential conflicts of interest between principals and agents. A conflict of interest between management and shareholders exists when managers seek to maximise their utility in a way that is not in the best interest of a firm's shareholders (Jensen and Meckling, 1976). A moral hazard problem arises if external investors cannot observe the choices that made by managers (Walker, 2013). In order to maximise their interests, agents are willing to present a good picture of the firm's financial position to shareholders. In charities, management take no personal financial risk and donors are in no way involved in decision making. The situation is not too dissimilar to the role of shareholders of a corporation who are predominantly detached from the decision-making process. Likewise, in charities, senior management makes decisions and unsophisticated donors are not directly involved operationally. Shareholders of commercial sector organisations are likely to follow the financial reports and news pertaining to the companies in which they own shares more closely, due to their personal tangible monetary gains either through capital growth or dividends. On the contrary, there are no direct financial gains to be had by an individual donor of a charity. Agency relationships arise between two (or more) parties when one, designated as the agent, acts for, on behalf of, or as a representative of the principal (Ross,1973). Extensive research has attempted to understand the business world in light of this agent-principal relationship. According to Jensen and Meckling (1976), agents can use the funds from principals by making operating decisions that are harmful to the interest of external investors. In the same vein, I attempt to investigate whether trustees and managers of charities can also make decisions which may not be serving the purpose for which their charities are funded. When one party is in possession of more information than the other, this creates information asymmetry. According to Kitching (2009), information asymmetries in nonprofit organisations are higher than in corporations because there are two groups of principals of a charity as opposed to only one in corporations. These agency problems are nontrivial in nonprofits, due to the under-supply of monitoring by principals, consumers, and regulatory institutions (Johnson & Prakash 2007). These two groups are donors and beneficiaries of goods and services; contrary to just the shareholders as principals in for-profit corporations. The basis of agency theory is that the managers are usually motivated by their personal motives. In a charity setting, there are groups of donors who would be unable to transparently observe the flow of

resources from them to the beneficiaries. This can be more challenging if the quality of financial and non-financial information is compromised. The situation is expected to be exacerbated if managers' compensation is somehow linked to the performance of a charity. If certain numbers are more "acceptable" from donors' point of view then management of such charities that remunerate their employees on the basis of performance are more likely to manipulate their financial reports.

In the capital market context, according to Healy and Palepu (2001), regulation, contracting and information intermediaries are the means of minimising information asymmetry. I posit that in a similar fashion information asymmetry in charities is reduced through the correct application of Statements of Recommended Practice (hereafter SORP). Over the decades, the sector's regulator, the Charity Commission, has revised and improved SORPs. Charities' rating agencies such as GuideStar UK and Charity Clarity help donors in comparing between charities and they effectively act as information intermediaries in the charity sector. However, analysis of these rating agencies is less sophisticated than financial analysts and rating agencies that exist in capital markets. This points to the possibility that information asymmetry can be more pronounced in charities. Add to this, the suggestion that two principals also increase information asymmetries in charities (Kitching, 2009), then there is potential for motives for financial misreporting in charities.

2.2.2 Resource dependency theory

Although agency theory applies to various situations within the nonprofit sector, the apparent appeal and applicability of agency theory in this context is rather limited (Steinberg, 1990; Herman and Heimovics, 1991; Brody, 1996; Helmig et al. 2004). In the absence of owners as principals, sociology's resource dependency theory (hereafter, RDT) can provide another appropriate and relevant framework (Pfeffer and Salancik 1978) to study the charity sector, which demands modification to fit the unique setting.

RDT framework appears relevant to explain the behaviour of charities' managers in response to various resource-related constraints. RDT implies that managers exercise strategic choices within the context of constraints (Greening and Gray, 1994). An organisation's degree of dependence is determined by the importance and

concentration of its resources (Froelich, 1999). I employ this theory within the realms of financial reporting and assert that accounting choices made by charities could be influenced by the importance and concentration of their funding sources. In order to manage resource constraints of funding, the accounting choices could be biased where subjectivity is involved.

The survival of an organisation depends on acquiring and maintaining its resources (Pfeffer and Salancik, 1978). This theory builds upon the role that environments play in shaping the behaviour of organisations (Levine and White 1961; Thompson 2011). Nonprofits cannot raise funds through capital markets, and voluntary contributions may be insufficient for the task at hand (Anheier, 2014). In addition, a firm's managers are expected to have discretion in reducing resource uncertainty.

According to Pfeffer and Salancik (1978), the behaviour of an organisation is impacted by the demands of the stakeholders upon which it depends for resources and support. They further suggest, "the key to organisational survival is the ability to acquire and maintain resources." The theory focuses on the bearing of external forces on attempts to manage its dependencies on external groups (Greening and Gray, 1994). According to RDT, dependence experienced is determined by the importance and concentration of its resources (Froelich, 1999). Therefore, according to this theory, the source and pressures on resources faced by charities may impact their decisions in financial reporting.

2.2.3 Legitimacy theory

In addition to RDT, legitimacy theory is also relevant to understanding the pressures faced by charitable organisations and incentives for misreporting. In fact, I can find links between legitimacy theory and RDT. Legitimacy is the central resource that organisations require for long-term survival (Anheier, 2014). Legitimacy refers to a general perception or assumption that an entity must act in a desirable and proper manner within some socially constructed system of norms, values, beliefs, and definitions (Suchman, 1995). Legitimation is a process whereby an organisation justifies to a peer or superordinate system its right to exist (Maurer, 1971). Likewise, it is also about the conformity to the norms of acceptable behaviour in the larger social system (e.g. Parsons, 1960; Dowling and Pfeffer, 1975). Charities that are more

concerned with legitimising their existence instead of providing ethically driven accounts of their efficiency may face incentives to report in a way that conforms to norms regardless of the transparency of the reporting (Hyndman and McConville, 2016).

Legitimacy theory is also relevant in understanding what motivates charity management to manipulate accounting numbers. “*Legitimacy is a generalised perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions*” (Suchman, 1995, p574). Legitimation is a process whereby an organisation justifies to a peer or superordinate system its right to exist (Maurer, 1971). Likewise, it is also about the conformity to the norms of acceptable behaviour in the larger social system that organisations are keen to aim for (e.g. Parsons, 1960; Dowling and Pfeffer, 1975).

Charities face public scrutiny if they are not seen to conform to certain norms. Such organisations also face the risk of increased “Political costs” that refer to the costs of additional regulation, including higher taxes, borne by large or high-profile firms (Watts and Zimmerman, 1986). The most applicable political costs within the charity sector setting is likely to be the cost of regulation and impact of some statutory inquiry by the Charity Commission to whom it is required to publish in the public interest under section 46 of Charities Act 2011.²⁶ Such inquiries, by attracting the attention of funders and media are expected to put the future of such charity in jeopardy by affecting future income and even risking being barred from operating altogether.

Although this study does not directly address fraud within the sector, *The Fraud Triangle* developed by Donald Cressey (Cressey, 1953) can also assist in understanding the behaviour of an individual who can violate a position of trust in order to resolve their personal financial problems. *The Fraud Triangle* comprises pressure, opportunity and rationalisation. *Pressure* comes into play when the job or business is in jeopardy. Likewise, many people commit white-collar crimes in order to maintain their social status. Such individuals should be able not only to misappropriate the funds but also must have an *opportunity* to do so. The third side of the triangle

²⁶ <https://www.gov.uk/government/collections/inquiry-reports-charity-commission>

is *rationalisation*. Most fraudsters perpetrate fraud for the first time and attempt to justify i.e. *rationalise* their act in order to satisfy themselves that they have not done anything wrong. To illustrate, they may rationalise that they would do it only to provide for their families, or that they were entitled to the money, or that they were being underpaid, etc.²⁷

2.3 Literature on financial misreporting in the charity sector

Hyndman and McConville (2016) suggest that there are charities that are more interested in legitimising their existence instead of providing ethically driven accounts of their efficiency. I posit that the quest for being seen as adherents to SORP and other conventions and legitimating their accounting practices amongst other things, may paradoxically lure charities into acting in the very way which standards are designed to steer them away from. Eldenburg and Krishnan (2008) in their study of government-run hospitals note that such organisations are constrained in incentive pay practices but they need to prove their efficiency to receive adequate funding. The authors suggest that such hospitals are more likely to use accounting information for legitimacy in the eyes of regulators and stakeholders.

The extant literature identifies a small surplus as a desirable position for nonprofit organisations (Leone and Van Horn, 2005; Ballantine et al. , 2007; Stalebrink, 2007; Eldenburg et al., 2011; Verbruggen and Christiaens, 2012; Vansant, 2016). Furthermore, a charity's management is free in deciding where to spend funds from its unrestricted sources, as long as they are in pursuit of the objects for which the charity exists. Unrestricted surpluses are also relevant because they feed into the balance sheet reserves. The use of restricted funds is not discretionary for management. Restricted income should only be used for those purposes stipulated by the donor. An excess of this income over the related expenses ends up in the balance sheet in the form of restricted funds. Restricted and unrestricted funds are kept

²⁷ <http://www.acfe.com/fraud-triangle.aspx>

separate in the form of columns. Likewise, endowment funds and designated funds are also allocated to their respective columns.²⁸

In addition to the above, the literature points to the need to reduce the cost of debt as another motivation for manipulation; and organisations do it by reducing the variance of earnings around a threshold (Trueman and Titman, 1988; Jaggi and Lee, 2002; Leone and Van Horne, 2005). This could also be explained as earnings smoothing. A considerable number of large charities have debts on their balance sheets and therefore a charity would avoid volatile net incoming or outgoing resources (terms used for surpluses and deficits, respectively).

The extant research also refers to the association of management compensation with the accounting data. Baber et al. (2002) find that changes in compensation are positively associated with changes in programme spending; pointing to the theory that a charity with a higher ratio of programme (charitable) activities will attract higher amount of compensation for its management. However, financial rewards are not the primary motivators for many nonprofit employees (Leete, 2000). Reporting of programme spending can be a tool for signalling the legitimacy of a charity to its donors.

If a large charity is not a household name and its donations are not impacted by the level of top management's remuneration then there is a possibility that top management's compensation may be relatively more generous. According to a Third Sector study, generous pay packages are more common in certain types of charities which do not depend on small donations.²⁹ Negative media attention vis-a-vis CEO and top management compensation in charities has been an area marred by controversy.

²⁸ The Statement of Financial Activities (SoFA) and Balance sheet of a charity are presented in the form of columns, typically including unrestricted funds (which can include designated funds in addition to unrestricted income) and restricted funds that can have endowment funds in addition to restricted income.

²⁹ http://www.thirdsector.co.uk/charity-pay-study-highest-earners/management/article/1335060?utm_medium=EMAIL&utm_campaign=promotion&utm_source=20170430&utm_content=TSFTESEmail2&spMailingID=17087224&spUserID=MzU4MjlyNjQwOTE1S0&spJobID=1002541771&spReportId=MTAwMjU0MTc2OQS2

Hofmann and McSwain (2013) review the scant but predominantly quantitative literature in the US nonprofit sector setting, specifying various motivations. Various studies posit protecting tax-exempt status, attracting donations, meeting grant criteria, avoiding political costs, improving watchdog ratings, enhancing managerial and organisational reputation and managerial compensation for financial disclosure management. UK charities are exempt from tax on their charitable activities; whereas only the activities which are not related to their mission are taxable. However, given the diversity of organisations within the sector, the financial reporting may not be as specific and clear-cut for a particular charity as donors would hope to see, as all organisations within the charity sector follow the same set of recommended practices.

In the first major study of UK charities, Bird and Morgan-Jones (1981) identified that in order to show low revenue to attract donors, a number of income-increasing items were capitalised by charities such as legacy income and gains on disposal of fixed assets. It is important to note that under current rules legacy is required to be recognised separately.

Hyndman (1990 and 1991) suggests that administration costs (including fundraising costs) as a percentage of total expenditure is the most important type of financial information required by contributors. Connolly, Hyndman and McConville (2013) also report that since the introduction of SORP 2005, the charitable activities ratio as calculated from the face of the SoFA increased significantly. This points to the possibility that managers may choose to manipulate accounting numbers on the face of the SoFA as average users would not look at the notes to the accounts to investigate allocations of support costs into charitable activities, fundraising and governance costs.

A major portion of the research in this area has been specifically focused on US-based nonprofit organisations. Studies in the US also note that programme ratios have reportedly been commonly altered through intentional manipulation as well as unintentional errors, and there has been empirical evidence that managers pursue high programme ratios (e.g. Tinkelman 1998; Baber et al., 2001; Trussel, 2003; Hager and Greenlee 2004; Wing et al. 2004; Khumawala et al. 2005; Roberts 2005; Jones and Roberts 2006; Krishnan et al. 2006; Keating et al. 2008, Tinkelman, 2009; Parsons et al., 2012). The programme ratio refers to the percentage of expenses relating to the

programmes and services of a charity to its total expenses. As far as donors are concerned, their main interest is in knowing how much every pound they donate is spent on charitable activities (Parsons, 2003); so in other words, they would like to see as high programme ratio as possible. Prior literature also reflects that nonprofit organisations gain through better funding when they present the breakdown of their expended resources with a larger portion serving those charitable objectives that a charity is founded on. There is a positive association between programme ratio and donations (e.g. Buchheit & Callen 1994; Okten & Weisbrod, 2000; Parsons, 2006, Gordon et al., 2009 and Thornton & Belski, 2010).

Where in the US it is the programme ratio that is a common point of reference; in the UK, fundraising costs draw the attention of the external stakeholders and management. It is important to note that the desire for low fundraising costs or a high programme ratio are two sides of the same coin. Therefore, different expense ratio measures are used by different donors in assessing the efficiency of a charity.

The empirical analysis of US charities' data supports this notion that charities with a high programme ratio (low fundraising ratio) are viewed favourably by the donors. Gordon et al. (2009) empirically test and find evidence that rating changes were associated with an increase in contributions. In the US, a number of private agencies such as Charity Navigator and GuideStar provide financial information of charities on their web sites to assist donors in deciding between charities. Organisations that faced a decline in rating were associated with accordingly reduced contributions. In the UK, GuideStar UK, Charity Clarity, GiveWell, aliveandgiving.com etc, exist for the same purpose but are a far less commonly used source of information. The Charity Commission maintains financial data of all UK registered charities and keeps copies of their financial statements for public inspection. Similarly, now most large UK charities' accounts can also be accessed directly through their websites.

These *“unintended, unfortunate consequences of unreasonable donor and monitoring agency expectations”* for a charity lead to accounting manipulation and charities have pressures to keep their fundraising costs under a certain percentage (Tinkleman, 2009). Nonprofit organisations' managers also face pressures to report favourable ratios that result in their willingness to manage ratios (Parsons et al., 2017).

The findings from the previous studies have been mixed regarding the impact of reserves on the future funding of charities in different sub-sectors (e.g. Marudas, 2004; Tinkelman and Mankaney, 2007; Chen, 2009; Wong and Ortmann, 2015). In the UK, the term reserves exclusively refer to “unrestricted funds” which the donors do not put restrictions on. This study also aims to contribute to the understanding and role of these reserves and their impact on future funding.

Disclosure is limited even in the largest of the UK’s charities (Hyndman and McConville, 2016). Therefore it is interesting to investigate whether charities also manipulate their financial statements in order to mitigate adverse publicity and secure future funding. Thornton & Belski (2010) posit that competition amongst nonprofit organisations incentivises managers to under-report fundraising costs in order to appear relatively efficient. Heijden (2013) through their experimental study indicate that accounting information affects donations to charities at the extreme ends of the shortlist, but charities that are in the middle do not benefit. However, sophisticated donors discount programme ratios (Yetman and Yetman 2013). Charitable organisations also aim to show zero profits on their taxable activities (Omer and Yetman 2003). Researchers have also suggested there are political costs associated with showing a sizeable surplus by a charity because that would lead to the assumption that the charity is not fulfilling its main objectives (Jones & Roberts, 2006; Leone & Van Horn, 2005, Ballantine et al. 2007).

Recent adverse media coverage and reports by the Regulator itself have become the primary motivation for this particular study. The report highlighted the Commission’s concern regarding disproportionately high governance costs and in some cases, erroneous classification of governance costs as support costs by several charities has been reported. Michelle Russell, Director of Investigations, Monitoring and Enforcement at the Commission, remarked *“I continue to be concerned that a large number of charities are not meeting the accounting requirements as set out in the Charities SORP and are making basic errors in their annual reporting. The incorrect reporting of financial information causes confusion has a real impact on public trust and confidence in charities and it is also likely to impact on how they are perceived by donors and potential supporters”* (The Charity Commission report, 2015).³⁰ The

³⁰ <https://www.gov.uk/government/news/new-report-suggests-charities-often-overstate-governance-costs>

documented problems with financial reporting also include a lack of consistency in narrative reports of charities; specifically, these tend to have varying degrees of details and quality.

Section 393 of the Companies Act 2006 requires directors to only sign the financial statements if they give a true and fair view. Likewise, the current SORP (FRS102) like its predecessors sets out the scope of a SORP which is to facilitate accounts that give a 'true and fair' view.³¹

In the UK charities, the earned charitable activities income has seen a sharp rise since the start of this millennium whereas voluntary donations income received by the sector has been gradually declining. Although the number of charities registered with the Charity Commission is in excess of 160,000 independent charities (Register of charities, 2020),³² a very small fraction of this number receives the major bulk of the total income for the sector. Therefore, this study focuses only on large UK charities in the sector. Also, I expect that the users of financial statements of large charities would be significantly larger than small charities.

There are both monetary and non-monetary motivations which can dictate the behaviour of a manager to misreport. Non-profit workers are more likely than their commercial sector counterparts to offer themselves for volunteering (Houston, 2006). As discussed above, albeit less than in public companies, performance can have bearing on compensation in the sector. In a report commissioned by The Charity Commission, public confidence has been low regarding the level of competence of managers in the Sector³³ and therefore I have a priori assumption that charity managers would be conscious of the overall trust and are expected to employ various methods to preserve their reputation.

Although the prior literature collectively points to motivations for misreporting in various US settings, this study aims to consolidate the most common motivations in one study to shed light on the UK nonprofit setting through in-depth interviews. Changes in the

³¹ http://www.charitysorps.org/media/619101/frs102_complete.pdf

³² <https://apps.charitycommission.gov.uk/showcharity/registerofcharities/RegisterHomePage.aspx>
(Accessed 16/04/2020)

UK SORPs over the last decade have improved consistency across charities and predominantly improved transparency but paradoxically also posed some challenges for the managers of these charities to show a truer picture of performance by misreporting financial statements. In light of the theoretical background and limited empirical evidence in the charity sector, I address the following questions;

- Do UK charities have motivations to manipulate financial statements; and if they do, then which numbers are most prone to manipulation?
- Are there any particular opportunities that facilitate this manipulation?

2.4 Methodology

The research population for this study constitutes the UK's one thousand largest charities by income – i.e. organisations established for charitable purposes as defined by the Charities Act 2011 and registered with the Charity Commission, the regulator of the sector in the UK. These charities engage in a very wide range of activities, from feeding the homeless to finding cure for diseases.

The data collection method for this qualitative research was the semi-structured interview, in which similar questions are asked of all interviewees but with some variation in the wording and the order in which questions are asked, and with the use of prompts and probes to follow up initial answers (Bryman & Bell, 2015). Semi-structured interviews are probably the most common type of qualitative method (Kitchin and Tate, 2000). This form of interview is recommended for the investigation of complex behaviours, opinions, and emotions (Longhurst, 2009). It provides insights into attitudes and perceptions that cannot be accessed by questionnaire surveys or structured interviews (Bryman & Bell, 2015) because its flexibility allows the researcher to “dig deeper into the mind of the interviewee” (Blumberg et al, 2005, p193). By employing semi-structured interviews, I make a methodological contribution, because the existing literature lacks an in-depth study of the motivators of financial reporting manipulation in UK charities. This methodology is *‘useful for investigating complex behaviours, opinions and emotions and for collecting a diversity of experiences’* (Longhurst, 2009, p.135). This would not have been possible through survey designs such as questionnaires or structured interviews. Interviews were

guided by a protocol containing a list of questions derived from the extant literature (Appendix 2.1).

An interview guide was set up containing questions designed to explore a list of possible motivators that was prepared from the extant literature. The interview process followed a natural flow with each interviewee's context in view, to ensure they elicit the relevant information comfortably and openly. Each interviewee's unique setting was considered in framing questions and analysing responses. New themes with changing times are not expected to be sufficiently captured by limiting structured questions considering only to the existing literature.

Qualitative enquiry typically focusses on detailed data from small samples of participants (Patton 1990, Richards 2005) so that it can illuminate the questions under study with a sufficiently intensive analysis of the data (Kuzel 1992; Gaskell 2000). Issues of prevalence are not an issue in qualitative research, where "phenomena need only appear once to be part of the analytical map" (Ritchie et al, 2014: 117). Hence, a sample does not need to be of a size that justifies quantitative estimates or statistical significance (Ritchie et al, 2014). Some recommend a minimum of a dozen interviews (Adler & Adler 2012; Guest et al, 2006), while Gaskell (2000: 43) suggests that the number of interviews be kept sufficiently low for the researcher to be able to 'recall each setting and participant, and the key themes of each interview'. My relatively small sample is justified by the use of a single, dichotomous sampling criteria (the main type of income source) and the concentration on a sub-group of the overall charity sector: the larger charities (see Bryman & Bell, 2015; Ritchie et al, 2014).

My research looks at the perspective of charity accountants in the UK through semi-structured interviews that examine whether the charities would be interested in misreporting their financial statements. To investigate if there are incentives for charities to manipulate accounting numbers I interviewed eleven charity accountants with internal knowledge, and three external professionals – including two auditors and a banker for some of the largest UK charities. This approach is similar to Gibbins et al. (1990) where they studied corporate financial disclosure by interviewing "*internal informants*" (Financial controllers or similar) and "*external informants*". Semi-structured interviews have not been employed by researchers as a methodology to study motivations, opportunities and methodologies of financial disclosure management practice in UK charities accounts. The analysis of these interviews is presented in the succeeding section.

The sampling frame for this study consists of the UK's largest one thousand charities by income. The primary sampling criterion was the main income source: "fundraising" or "earning". Here I classify those charities as *funded* if they receive the majority of their income through voluntary contributions. The terms broadly equate to Charitable and Service-oriented types (see Balsam and Harris, 2014) in previous literature. Instead, for this paper I use the terms "Fundraising" (coded as FR prefix for the interviewees from Fundraising type charities), similar to Charitable and "Earning" (coded as ER prefix for the interviewees from Earning type charities) similar to Service-oriented. Those charities that receive a larger portion of their income in exchange for services or trade have been categorised as *earning* charities for this study.

The achieved sample consisted of eleven charity heads of finance or senior personnel in similar positions. All interviewees were senior chartered accountants or chartered management accountants. I used criterion-based, *purposive* sampling (e.g. Masson 2002; Patton 2002). I set out to interview qualified accountants with significant experience in the sector and representing two broad classification of charities. My secondary sampling criterion was the charities' substantive areas of work: in order to identify whether there are any motivations specific to various sub-groups, I included a variety of sector sub-groups. The represented charities engaged in a range of activities and had annual incomes ranging from £12m to above £300m (Figure 2.1). All eleven charities gain their income from a range of sources: fundraising, charitable activities, trading etc. In the text, I label the participants according to their dominant income source: FR (Fundraising; n=6) and ER (Earnings; n=5).

To recruit the participants, emails were sent to a random sample of the available email addresses from a sampling frame of largest UK charities; these invited heads of finance to participate in the study. Figure 2.1 describes the eleven charities to the extent that is possible without compromising their anonymity.

The charities below include those where the heads of finance interviewees are employed

Charity ID	Income bracket	Charity sub-group
FR1	£300m-310m	International activities
FR2	£120m-£130m	Social Services
FR3	£25m-£35m	Professional Association
FR4	£10m-£20m	Medical Research
FR5	£25m - £35m	Income Support and Maintenance
FR6	£10m-£20m	Grant-making foundation
ER1	£10m - £20m	Economic, Social and Community Development
ER2	£20m-£30m	Development and Housing
ER3	£15m -£25m	Economic, Social and Community Development
ER4	£15m-£25m	Culture and Arts
ER5	£25m - £35m	Primary and Secondary Education

Other professional interviewees

AUD1	Senior Nonprofits Audit Manager at a top Global Accounting firm
AUD2	Nonprofits Audit Manager at a top Global Accounting firm
BNK	Relationships' Director at a top UK bank

Figure 2.1: List of charities

Almost all the email addresses were generic and therefore may not have reached the intended participants directly. Efforts were made to search for the contact details of senior management at large charities but such information was not readily available. It is not known how many charities would have effective internal communication to deliver the interview request to the intended personnel. In light of the responses from some charities and some that did not respond, it is understood that several charities are constrained by time and resources for academic research. Similarly, a large number of preparers of financial statements to agree to this interview is not expected especially when the questions are expected to probe about financial statement manipulation; so it is possible that those engaging in most manipulation are not

captured in the sample. Therefore, the value of the available data is in the evidence of manipulation from the direct quotes of the preparers of financial statements.

Although the sector is very diverse and there would always be unique data for each charity, the type of evidence sought in this study is expected to have wider relevance. These interviews can be classed as convenience samples (e.g. Creswell, 2013; Berg and Lune, 2012; Patton, 2002). The two senior audit managers were accessed through the UK head of assurance at a top global audit firm. A *Relationships Director* at a leading UK bank was interviewed in order to understand the benchmarks set by a bank whilst lending to the sector. This interview was included because some of the finance director interviewees had referred to debt covenants but declined to divulge details on account of their being “commercially confidential”. This interviewee currently looks after circa forty charity clients and deals exclusively with lending to the nonprofit sector which, in his words, is his sector of “specialism”.

All interviews were recorded after gaining explicit, written consent from the interviewees and were subsequently transcribed for coding.

During the analysis stage of the interviews, thematic analysis was used to analyse the data with a framework approach facilitating this process (Ritchie, et al, 2014; Bryman & Bell, 2015). The relevant themes were identified and guided by theory and extant literature. Interpretative strength of the analysis was enhanced in light of theoretical framework and therefore primarily the analysis was theory-driven but any deviations were also noted that emerged from the data. Figure 2.1 depicts the two income categories (primary sampling criterion) and subgroups of the sample charities according to their objectives. Exact incomes have been veiled and instead ranges of income have been presented to preserve the anonymity of the interviewees and their charities.

2.5 Analysis of results: Motivations for financial statements misreporting

This section presents a detailed analysis of the interviews and lists and expounds on various themes that were identified as motivations for financial statements misreporting.

The following section presents the main themes identified with examples of responses from the eleven finance directors. Thematic analysis was used to analyse the data

with a framework approach facilitating this process (Ritchie, et al, 2014; Bryman & Bell, 2015). The relevant themes were identified and guided by theory and extant literature. Before presenting specific accounting areas that face pressures, I begin with discussing whether financial reporting-related pressures, either perceived or real, do at all prey on managers' minds.

Most interviewees acknowledged the presence of pressures coming from donors and that these can prompt financial misreporting. For example, one interviewee acknowledged the importance of the emotional factors influencing some donors and the implications of this for reporting: "*Funders are not logical are they. Fundraising is about emotions...if you're competing for funding with a similar organisation*" then comparisons with a close competitor will be inevitable, "*because of the way financial statements are*" (FR2). Therefore, charities would face pressures to stay within the norms of their peers.

The above suggests that financial statements play an important role, especially when charities compete with similar organisations for funding. The pressure to misreport may depend on the sophistication of funders and their level of familiarity with charity accounting. A surplus/deficit in charities is not as simplistic as an earnings figure is in a company. When asked whether trusts and foundations were interested in accounting data before making donation decisions an interviewee replied "*yes, always!*" Such relevance is expected to be less if the assumed understanding of charity accounting is limited: "*if they're not a financy (sic) person then maybe not. Community and (donors at) events, I doubt if many of them look at our reports*" (FR2).

Therefore, the relevance of accounting numbers appears to have a link with the sophistication levels of the users. Trustees' lack of familiarity with accounting can also put pressure on accountants to manage accounting numbers in such a way as to avoid scrutiny of the charity's position or performance. For example, one interviewee noted that: "*I'm not unprepared to manipulate the way that I report information in order to put us in the best light with stakeholders and others.*" (ER4). As this illustrates, some charities are cognizant of donors' needs and are prepared to manipulate their reports to address these needs.

Responses also highlighted that the economic environment can impact the level of pressure from resource dependency. In periods of financial distress and strained

resource dependency, the trustees of financially distressed charities “*may be more manipulative I’ve found...(it) depends on the trustees and how competent they are; because I’ve been with trustees who just really care about what they (financial statements) look like.*” Alluding to the resource dependency pressures, the interviewee further said, “*Most charities had to put people on notice of redundancy because you don’t know where the funding’s coming*” (FR2).

There was some evidence of pressures other than resource dependency – such as employees’ desire to be awarded bonuses. Some fundraisers can persuade accountants to manipulate accounting numbers. One interviewee reported that a fundraising colleague had said to them, “*make things look good so that they can get their bonuses at the end of the year*” (ER1).

The interview data highlighted three major accounting areas as likely to be manipulated in response to resource dependency pressures. These are discussed in the next subsections. They include reserves (unrestricted), fundraising costs, and bottom line income (surplus/deficit). The pressure on the reporting of these areas and accounting responses vary according to the funding sources.

The interviews highlighted six recurring broad motivations or pressures for misreporting financial information: 1) preservation of income; 2) peer benchmarking; 3) averting debt covenant breaches; 4) securing jobs and employees’ compensation; 5) safeguarding professional reputation, and 6) guiding less acquainted charity accounting users.

The data reveals that the leading financial challenge faced by charities is the unpredictable and unsustainable future income. Various factors that I call “subordinate motivations” were identified that directly or indirectly affect the first theme, the need to preserve future income, which has been reported separately. These “subordinate motivations” included the need to regulate reserve levels, rising overheads, shifting trends from voluntary to earned income and variations in reported income due to changes in SORP.

In addition to the above, the data suggests that amongst charities that are faced with motivations to manipulate accounting data, poor audit quality, ineptness of trustees, unsophisticated funders and period mismatch in income and expenses might increase

the likelihood that accounts are misreported. I call them “facilitators”, as they increase the likelihood that motivation to manipulate is translated into manipulation.

As a result of the contemporaneous media attention on mismanagement of charity resources (e.g. over the Kids Company affair),³⁴ some interviewees expressed concern over dwindling public confidence and trust. Participants of the study expressed disquiet over the deteriorating public perceptions of charity sector management. As one interviewee said, *“I’m just slightly worriedof course everybody wants when they give their pound that their pound is going to a frontline service.”*

Interviewees also commented on the importance of non-financial data. Whilst discussing the direct or indirect impact of accounting numbers on compensation it is important to note that manipulation of non-financial data is not just possible but also directly beneficial for employees – i.e. by exaggerating success at meeting KPIs. Such manipulation can have *“more incentive than just the accounting numbers.”* In some charities, employees’ compensation is directly linked with reported KPIs and these are shown in the annual report. One participant said that over and above their base salary a bonus is added if the organisation achieves certain business goals and that the income of an employee would simply drop if they do not achieve those target KPIs. A senior chartered accountant said, *“there is more challenge to keep us honest in how I report the KPIs.”* It appears that the incentive to misreport is not only strong because management compensation is linked to such targets, but also because of how easy it is to report them in a way that serves vested interests. As one participant put it, *“there’s more challenge to keep us honest in how we report the KPI’s and things like lives you’ve improved tends to get a bit subjective and you can get carried away and go too far down” (FR5).* A senior auditor also confirmed the importance of KPIs, by saying that they are mindful of specific audit risks associated with such performance related packages which sometimes are linked to *“financial targets or financial KPIs” (AUD1).* Therefore, showing good KPIs is in every staff member’s interest. In order to maintain their independence, finance teams are not supposed to be incentivised in the same way as others but the rest of the teams are incentivised through performance based

³⁴ Kids Company underwent the inquiry by charities commission was opened after increasing number of allegations in the public domain about its governance and financial management. Amongst many others this was a typical example of agency problems where £800,000 were being paid for monthly wage bills out of government’s £3m grant, even when the company was facing huge challenges to its sustainability. Kids company went into insolvency and was found up under court order in August 2015.

awards. In light of the available evidence, it appears that resource dependency pressures are a likely cause of financial misreporting.

As the focus of this study is manipulation of financial statements and particularly of the SoFA and Balance Sheet, the following analysis deals exclusively with the motivations to manipulate accounting data.

2.5.1 Preservation of future Income

In many respects, the ultimate motivation for a charity is to secure its future funding to remain in business. For a fundraising charity that generates income through donations, legacies or grants, the income also depends on shrewd techniques with a degree of a sentimental appeal; as one interviewee commented *“funders are not logical are they? Fundraising is about emotions.”* (FR2).

For a fundraising charity, *“if you’re competing for funding with a similar organisation”* (FR2) then comparisons with a close competitor will be inevitable *“because of the way financial statements are; you will sort of think is my fund raising costs lower than somebody else or higher than somebody else? Have I got higher reserves or lower reserves?”* (FR2). Endowment charities may be comparatively immune to certain cuts by the governments or corporations but they would be affected by the performance of their funds in stocks and shares and other investments.

On the other hand, an earning charity i.e. a charity that competes with other peers for contracts of services or sells its merchandise, faces pressures and incentives which are different from its fundraising counterpart. It needs to employ techniques which are akin to commercial organisations as one interviewee whilst referring to *“pure mismanagement”* (ER1) of an earning charity said *“(the charity) just didn’t have people who had commercial skills to make sure that contract got fulfilled.”* (ER1). I therefore posit that the incentives are different for earning and fundraising charities.

There appears to be an amplified motivation for the fundraising charities to show low levels of surplus, fundraising costs and reserves to secure future income. The desire for a low bottom line figure was echoed by several interviewees including the finance director of a professional institute charity in which the main source of funding is in the form of membership subscription fees. He commented *“so long as I don’t make too much profit because otherwise all they’ll want is their fees reducing. What I do with*

their fees most of them are not that interested." (ER6). Therefore I theorise that amongst other types of charities professional institutes also have an incentive to show low surplus and reserves in order to justify subscription fees.

The goal for any charity is to fulfil its objectives and in doing so it needs to secure funds and ensure their perpetuation. There are various *subordinate motivations* or pressures that charities may face to preserve and sustain future income. The *subordinate motivations* lead to the overarching goal of maintaining income, and are described in the following sections.

2.5.1.1 Level of charity reserves

The level of reserves is an important consideration for charities and, surprisingly, the extant literature is largely silent in this regard. When asked about the most relevant accounting numbers a finance director said, *"I would probably say surplus and then the reserves"* (ER2). Another interviewee remarked *"Biggest pressures are reserves and charitable activities"* (FR3).

The issue of how much reserves to keep has always been contentious, as high levels of reserves attract the unwanted attention by the media and regulator. It is therefore a situation where one may argue that a little more conservatism would have been a safer option.

The Charity Commission's guidance on reserves states "All charities need to develop a policy on reserves which establishes a level of reserves that is right for the charity and clearly explains to its stakeholders why holding these reserves is necessary."³⁵ It is important to note that strictly speaking "reserves" only include free reserves which have no restrictions on them. On the other hand, I have noted that restricted funds may erroneously be referred to as "reserves" by even the accountants themselves. The use of restricted funds is not discretionary for the management. Restricted income is only used for specific purposes as postulated by the donor. An excess of this income over the related expenses ends up in the balance sheet in the form of restricted funds. Restricted and unrestricted funds are kept separate in the form of

35 <https://www.gov.uk/government/publications/charities-and-reserves-cc19/charities-and-reserves>.

columns. Likewise, endowment funds and designated funds are also allocated to their respective columns.³⁶

High levels of reserves are not desirable, particularly for a fundraising charity. They can lead to charities being “*accused of being too conservative and (making) inefficient use of capital*” (FR1). Talking about their well-known fundraising charity, a senior chartered accountant said, “*there are times when I deliberately make a loss because I’ve got more reserves than I need*” (FR2). A finance director of a medical charity said that their “*plan over the next 5 years is deliberately to have a deficit because I have reserves and I want to be able to use them so our trustees would be happy to see a deficit as long as it’s in the right place*” (FR3).

In their pursuit of legitimacy, earning charities are faced with a dilemma. It appears heightened pressures to reduce reserves can potentially lead to inefficient use of resources to augment legitimacy. That is to say there is a risk that the pursuit for depleting the reserves may become the focus and not necessarily the consideration whether there is a genuine need to reduce the level of reserves. Depleting reserves to appease certain stakeholders in the short-term may come at the cost of the long-term viability of a charity.

In their effort to deplete high levels of reserves, fundraising charities are motivated to make small surpluses or deficits. They do so while ensuring that a major portion of the costs is not shown as fundraising. This is because “*trustees would be happy to see a deficit as long as it’s in the right place..(if) I spent more on fundraising or on central costs, they wouldn’t be happy*” (FR3). This statement signifies the pressure from trustees when the main focus is not about spending on the most appropriate causes but it is to reduce reserves by showing deficits in the correct column i.e. unrestricted earnings column; that would eventually feed into the unrestricted reserves. Those charities that are funded by trusts and foundations are likely to be keener on keeping their reserves at optimum levels. There were instances described by some

³⁶ The Statement of Financial Activities (SoFA) and Balance sheet of a charity are presented in the form of columns, typically including unrestricted funds (which can include designated funds in addition to unrestricted income) and restricted funds that can have endowment funds in addition to restricted income.

interviewees where trusts and foundations have not hesitated in providing feedback regarding their reason for keeping high reserves.

From the above discussion I infer two important points. Firstly, the level of reserves is an important motivation to manage charity accounts because a charity could potentially be willing to make deficits in the foreseeable future rather than have high reserves; I find that *fundraising* charities have stronger incentives to do so than *earning* charities. Secondly, by showing a lower fundraising ratio, charities can aim to counterbalance the negative impact of sustained (deliberate) deficits that are accepted to deplete reserves and legitimatise the management by showing their competence in suitably running the charity.

One such comments that reinforce the earlier discussion was *"I know that I have had grant applications rejected on the basis that our reserves were too high or our fundraising costs were too high so they definitely are making decisions on the basis of those"* (FR3). My inference above that high level of reserves could be a deterrent for future donations was corroborated by the auditors too. One auditor said *"if you've built up, for whatever reason, a high level of unrestricted reserves...you'll end up with funders looking at your accounts and saying why are they applying to me for funding"* (AUD1).

On the contrary, a lending institution or a bank would be interested in knowing the breakdown of various funds to assess the financial health of their client charities. *"One of the other things I look at particularly in charities obviously is what have they got in reserves, what's restricted, what's designated, what's unrestricted"* (BNK). Here it is also evident as discussed above that several users of financial statements refer to all funds as "reserves" including the restricted funds; which is technically an incorrect term and points to the complexity of charity accounting in comparison to mainstream accounting that most stakeholders are expected to be better accustomed to. Although it was not the main focus of this research, I note as a side point that some interviewees expressed their disappointment that by not being able to accumulate reserves they were less prudent and therefore unable to keep a buffer for a rainy day. Hence, a careful balance is needed between being responsibly cautious and yet seen as a charity that spends on worthy causes while not excessively accumulating funds.

2.5.1.2 Rising overheads

The Charity Commission reports that charities tend to either overstate governance costs or inaccurately equate governance costs with support costs (such as general management and administration costs).³⁷ The latter however may not be as objectionable as the former. If a charity has high amounts of indirect costs which are subject to apportionment, the interviews suggest that there will be incentives to misallocate more into charitable activities.

Donors disapprove of overhead costs and the level of donations has been linked with overhead costs.³⁸ Strained income but rising overhead costs mean charities are under constant pressure to minimise the reported overhead costs. Those charities that have a large number of permanent staff would face a bigger challenge in curtailing costs as one interviewee said, *“it’s difficult to fire staff and can be expensive with redundancy costs and claims and so on.”* Therefore charity accountants can potentially be motivated to misallocate as in words of another participant *“pressure would be to allocate as much as possible (to charitable activities)” (FR3).*

An interviewee’s charity that spends *“seventy odd percent”* on staff costs which in their view was nondiscretionary and therefore difficult to cut down commented *“Well to be honest I’m not being funny it’s all how you decide to allocate” (ER2).*

An interviewee whose charity has high level of overheads, whilst discussing apportionment of these costs went as far as saying *“I’m not unprepared to manipulate the way that I report information in order to put us in the best light with stakeholders and others” (ER4).*

Even if I accept that scrupulous accountants meticulously work out true and fair estimates for allocating overheads, it could be a tedious exercise. An interviewee alluded to this by saying *“I’m still doing a massive manual overlay on the accounts, going through line by line to say do I believe that that allocation is right?” (ER4).* Another accountant remarked *““The pressure would be to allocate (support costs) as much as possible to charitable activities but again you have to be true and fair so it wouldn’t be true and fair if all of them relate to charitable” (FR3).*

³⁷ <https://www.gov.uk/government/news/new-report-suggests-charities-often-overstate-governance-costs>

³⁸ <http://hbswk.hbs.edu/item/donors-are-turned-off-by-overhead-costs-here-s-what-charities-can-do>

It is noteworthy that the new Charities SORP (FRS 102) which has been adopted by all charities for financial reports on or after 1st January 2015 includes governance costs within charitable activities and therefore its misclassification will directly impact the programme ratio. Most charities may not mind having governance costs attributable exclusively to the “favourable” expenses now. Those charities that resort to misclassifying support costs as governance costs will have an enhanced programme ratio.

A foundation charity also seems to be concerned with its level of indirect costs and not immune to the temptation to misclassify. *“From Foundation’s point of view it is the management fee which is like fundraising costs... their target is 90% programme ratio” (FR5).*

Funding cuts by the government³⁹ have added pressure on charities to render services for the causes that they exist for. The increase in yearly income is being outstripped by a surge in respective relevant costs, and in some cases even by the rate of inflation. One interviewee remarked *“Ok so for us the biggest challenge is that support is actually commissioned by a local authority... they are under a huge pressure to cut...they will offer five year contract.. now it is often starting to happen that the commissioners will set a ceiling price...no more than say £225,000 a year...everybody else is bidding at that and you know you have to come up with the winning price... we are about to hit the London living wage and the London living wage increases on an annual basis so our costs are going up on an annual basis but our income is fixed” (FR4).* This comment suggests that the charities bidding for local government contracts are under constant pressure to keep the quotes down despite increasing costs. I would expect such charity would aim to diversify its sources of income to remain financially sustainable. This includes income from other sources including donations from the public.

Severe funding cuts and their impact on charities was a recurring theme in the interviews. One finance director called such cuts from the local authorities “totally unsustainable” and “madness” (ER1). One finance director explained that now the

³⁹ <https://www.theguardian.com/voluntary-sector-network/2016/feb/11/grants-local-charities-campaign-appeal-government-cuts>

commissioners are setting price ceilings on five year contracts and they are not increasing the value of such contracts above inflation.

The finance director of a charity that runs independent schools remarked that *“making ends meet in the market where staff salaries go quicker than inflation, so people don’t want to see their fees go up at 3% but on the other hand teachers expect their wages to go up”* (ER5). Hence even an established independent school which would apparently have predictable income from fees also seems to be challenged by a steeper rise in overheads compared to its income. Hence resource dependency pressures appear a common theme in an otherwise vastly varied sector.

I infer that, for earning charities, costs that rise more steeply than income, are a cause for further strain on charities and therefore the pressure to increase income is pronounced in the current climate of austerity. Another comment from the finance director of a housing charity that predominantly earns through local government housing contracts that accounting numbers that may affect funding and therefore motivate management to manipulate them. The comment reads as follows: *“... (Local council) would really just want to make sure that your reserves were relatively strong and you were probably making a surplus or at least breaking even in theory, to be honest.”* (ER2).

2.5.1.3 Shifting trends from voluntary to earned income

As far as the income of the entire sector is concerned, in the past decade there has been a significant shift from grants to contracts mostly with local authorities and also with the central government.⁴⁰ It appears that the need for financial viability, which implies reasonable levels of reserves and surplus, would affect larger charities more, and particularly those charities that bid for sizeable contracts where *“the pre-qualifying questionnaire says you’ve got to be financially viable”* (FR2). Another interviewee got the feedback from a local authority for not being *“financially viable”* stating that *“this company is not financially viable to take on a contract of this size”* (FR2). As discussed

⁴⁰ For instance public-sector grants (voluntary income) added up to £6.11 bn in 2003-04 which had plunged to just £2.8bn by 2013-14. The picture of the change in government contracts (earned income and fees) is quite the opposite where it increased from £5.77 bn in 2003-04 to £12.17 bn in 2013-14 <https://data.ncvo.org.uk/a/almanac16/income-4/>

above, *fundraising* charities would stick to low reserves and low surplus. I posit that a notable shift from voluntary to earned income is expected to take the focus away from low reserves and low surplus to “*financially viable*” targets.

Another interviewee’s comment helps in understanding what a “*financially viable*” position may mean. An interviewee stated, “*whoever looked at the accounts at the local authority said this company is not financially viable to take on a contract of this size*” (FR2). A local authority in a contractual relationship would treat a charity like a commercial organisation which must appear “*financially viable*” as an assurance that the contractual obligations would be honoured. Another interviewee commented, “*contracts (commissioning entity) would really just want to make sure that your reserves were relatively strong and you were probably making a surplus or at least breaking even in theory*” (ER2). This comment was echoed even in more definitive terms by another accountant “*I run complex contract arrangements and performance arrangements and that leads us to try and have an even stronger focus on our unrestricted net income and our reserves as well*” (FR1). Contracts are acquired through the tendering process and then they are expected to be fulfilled in a similar fashion as in the case of the services provided by commercial organisations.

Likewise, interviewees referred to some accounting ratios of relevance such as quick ratio, gearing ratio, fundraising/programme ratio and interest cover ratio. A strong desire for a small surplus was noted across the board. Whilst discussing the most desirable performance according to SoFA, one auditor said that it would be “*stable bottom-line net incoming (resources) with a small positive*” (AUD2), hence confirming what the charity accountants said.

Financial viability, therefore, may refer to strong reserves, liquidity, profitability and solvency ratios, or a surplus under the unrestricted column. It is an increasingly important factor in assessing whether a charity has the capacity to fulfil contracts. I infer that this makes the incentives to manipulate accounting numbers similar to the commercial sector organisations where a charity is faced with incentives to turn its unrestricted deficit into a small surplus or regulate its bottom line figure in order to strengthen the unrestricted reserves.

On the other side of the spectrum, those charities that rely heavily on grants and cannot compete in winning tenders for contracts will have an added pressure of

showing *acceptable* amounts in their accounts too. I postulate that this shift from grants to contracts can further tighten the available funding to fundraising charities. The head of finance at a museum referred to the public sector funding cuts and its potential implications: “... *even the funding organisations have their own funds being cut by the government; they will have to compete harder to convince government and if accountants believe that reserves have a bearing on future grants then they would inevitably reduce their reserves which are high*” (FR4). Practical response of this could be manifested by some charities trimming their reserves by taking either very low surpluses or even deficits in subsequent years until a desired level of reserves was reached. “*In our case definitely...I should always be looking to spend our income...If I overspend, that’s equally bad*” (FR5).

Although it was not the focus of this research, some interviewees expressed their dismay that the consequence of a significant shift from voluntary to earned income through tendered contracts was responsible for pricing out smaller charities.

2.5.1.4 Peer benchmarking

In order to understand whether data in the financial statements of the nearest competitor could be a potential motivator, I found evidence that it was the case to a degree for some charities. A senior chartered accountant, who has worked at eleven charities in his/her long career in the sector, indicated that the charities do compare their financials with similar organisations that compete for funding. Therefore the content of financial statements and the way they are presented are relevant amongst the peer groups. There is an assumption on the part of the charity accountants that the competitors’ numbers are relevant as one participant said “*you will sort of think, (are) my fundraising costs lower than somebody else or higher than somebody else; have I got higher reserves or lower reserves? I guess the other people are probably looking at our competitors you know to sort of kind of judge really*” (FR2).

I also found evidence that funders compare peers’ financial statements. One finance director at a charity that gets its funding from a foundation trust revealed a funders’ cynicism regarding the reported numbers “*you are spending X on this while they are only spending Y. Why is it costing you X?*” (ER2).

The data suggests that some charities would be motivated to peer benchmark more than others; for instance, nationally acclaimed “*big players*” would be interested to know what “*the others have got in their accounts*” in a similar vein as in corporations; as one interviewee explained such comparison in their current as well as “*previous charity*” (FR3).

Likewise, such comparisons have a “*psychological*” effect for some accountants and exhibit a sense of competitiveness as one participant commented that they “*smile brightly when they (competitors) have got a deficit*” (ER2).

Some Interviewees expressed their frustration regarding inefficiencies in the sector where there are too many charities within each sub-group. I conclude that most organisations in the sector are likely to face some form of competition and the peer group for each charity would be determined by its sub-group, its scope of services, geographical location and the source or type of funding.

2.5.1.5 Debt Covenants

Interviews with charity accountants, auditors and a banker made it clear that the enforcement of debt covenants on charities may not be as common as in their for-profit counterparts. For those charities that do have debts with covenants attached to them, these are scrutinised by the lender for “*surplus for the year*” or as a certain “*multiple*” of the loan interest so there “*may well be an incentive to manage certain financial information*”(AUD1). I found evidence that debt covenants of those charities that have sizeable endowment funds are likely to be linked with the level of their endowment funds. Head of finance at a charity running independent schools said, “*I very often got a covenant....on the size of the fund’s endowment which goes up and down(to use) for working capital for our schools and if I do so....the bank will be interested*” (ER5). This particular interviewee was understandably reluctant to divulge further “*commercially confidential*” information in this regard.

Banks look at sustainable income for debt serviceability. According to the interviewed banker, an inconsistent stream of small donations and therefore the unpredictable income of particularly religious charities is viewed as a less safe investment from a bank’s perspective. The interviewee compared that with independent schools which are a much safer investment for a bank. I infer that this can potentially be an incentive

for a fundraising charity that depends on several small donations. A motivated charity may massage its accounts to appear more palatable to demonstrate sustainability to the lender. The banker revealed that a bank may consider scrutinising either financial performance in SoFA or examine cash flows that are calculated by the bank itself. The bank “*would expect debt to be serviced by X times on cash flow basis or EBITAD (surplus) basis*” (BNK). The banker did, however, suggest that for risky “*fundraising type*” charities, debt covenants “*will lean towards cash basis*” whereas for less risky and sustainable income-generating charities, the bank is more likely to consider the surplus as the covenant.

2.5.1.6 Employees’ compensation and job security

Although the earnings of top management are significantly less compared to the top public limited companies, they are still significantly larger compared to the mean or median of the overall working population.

This study suggests that performance-related pay may be limited to fundraisers or commercial directors employed by charities, and the management compensation in relation to accounting numbers may be less common in the UK charities sector than in commercial organisations. The charity sector has traditionally been vigorously scrutinised by the media. On balance, such pressures may be beneficial because they act as a deterrent and may compel charities to respond by improving various processes.

There has been an increase in the mean income of CEOs in the top 100 charities.⁴¹ It is conceivable that the top management of a charity would want to hold on to his/her role and if the financial statements have an impact on their salary or job security then they may be motivated to present a favourable picture. One auditor gave anecdotal evidence of a client charity where a new chief executive had recently joined. He

⁴¹ It was £255,000, in 2017 according to a study which compares with £212,500 in 2015. Household names do not feature amongst the highest paid; and the bulk of this overall increase comes from grant making foundations. <http://www.thirdsector.co.uk/charity-pay-study-2017-highest-earners/special-report/article/1427306>

<https://www.ons.gov.uk/employmentandlabourmarket/peopleinwork/earningsandworkinghours>

<https://www.theguardian.com/money/2014/mar/25/uk-incomes-how-salary-compare>

was “*very sensitive to the fact that the charity had been very good at keeping to its target of breaking even on restricted reserves for a good number of years under the previous Chief Executive*” (AUD1). In this instance the auditor did, however, factor that into their audit risk assessment of the client.

I found evidence that other than trustees, fundraising staff are particularly interested in how the expenses are classified between charitable activities and fundraising costs. Data suggests that funders examine these numbers minutely in order to make funding decisions as their annual bonuses may be linked with the funds; therefore there is an indirect link of accounting numbers to their future bonuses. A charity is expected to gain through more funds in future if the funder is satisfied with its accounting data and therefore will fund the charity. As far as fundraising staff are concerned, securing funding is their primary task. Fundraising costs ratios impact their job security and in many cases, their annual bonuses are linked with achieving these funds too. Fundraising teams also aspire for low reserves; according to one interviewee, their colleagues in the fundraising department “*are starting to get a bit nervous about the level of reserves and what our accounts are showing and how they can use that to explain to potential funders*” (ER4).

Another interview referred to some of the director level employees stating, “*some of the finance directors that I know making things look good so that they get their bonus at the end of the year for sure*” (ER1).

There are certain monetary incentives in the form of bonuses and even job security for some colleagues that can potentially convince a charity accountant to manipulate particular numbers in the SoFA as well as Balance Sheet. I found evidence that some fundraisers persuade accountants to manage numbers to help them achieve their personal targets. One interviewee revealed that a fundraiser said to them “*make things look good so that they can get their bonuses at the end of the year*” (ER1). Due to public funding cuts, the pressure to raise funds by the charities is mounting and although it is not a financial reporting issue, such pressures could potentially affect the accountants’ integrity too. One interviewee commented, “*..and most charities I know have gone through a phase where you’ve had to put people on notice of redundancy because you don’t know where the funding’s coming in or you’ve had to reduce hours or whatever because of the funding, but that’s not to do with financial reporting*” (ER2).

This study has also brought to light going concern issues faced by various charities in the wake of shrinking resources and intensifying competition. The main concern for several fundraising and earning charities is to sustain cash flow into the foreseeable future. In times of financially distressing motivations to raise funds to get stronger, any pressure from either fundraising teams or commercial directors to manipulate numbers directly or indirectly impacts everyone's job security; therefore it could potentially be a strong motivator to manipulate financial statements. A participant's colleagues in the fundraising department started to get a *"bit nervous about the level of reserves"* and what their accounts were "showing" and were wondering how they were able to *"explain high reserves to potential funders"* (ER4). Pointing to the emotive area of fundraising costs an interviewee stated that it was expensive to fundraise but the way numbers were reported opened one up to risk because *"nobody would want to see high fundraising costs"* (FR4). This statement also demonstrates a conundrum faced by charities; where on the one hand they need to spend on raising funds to remain competitive in a difficult market; but on the other hand, they may be compelled to camouflage even justifiable costs to appease the funders.

External professionals, the auditors, in the study confirmed that performance for pay incentives is not as common in charities as in commercial organisations. One auditor remarked *"maybe you've got fundraising targets at this level or more... and if you meet it you're in line for a bonus, but that being said, performance-related pay and bonuses don't feature as much in the charity sector as they would do in a more commercial sector. And so I see limited examples of that"* (AUD1).

Referring to the pressure from a commercial director who also happened to be a qualified accountant, an interviewee stated that they were approached and asked, *"could I not just do it like this cause it looks like I hit at our forecast?"* (ER1). This comment points to two matters; firstly, that the employees within a charity are interested in accounting numbers; and secondly, the benefactor would consider these numbers as an important factor in deciding whether to support a charity. Even if it is assumed that there are no direct monetary gains from manipulating numbers, or that the job security of only the fundraisers is affected by the amounts of funds raised, the ultimate goal for all employees is to see consistent growth in funds as it would ensure job security not just for the fundraisers but for all, including those tasked with financial reporting. The head of finance of a large fundraising medical research charity indicated

such motivation by saying *“I would say for me personally my motivation would be because I want to support my fundraising colleagues to make as much money as they can for the charity and would want to make sure that, yes, the Trustees were comfortable (too)” (FR3)*. According to this interviewee if fundraising colleagues fail to achieve fundraising targets then they may have to be answerable to management.

In light of the empirical evidence, I deduce that there are more incentives for fundraisers and commercial directors than for other personnel. Performance-related-pay exists in the sector albeit less prevalent but significant funding cuts and shifting to earned income as in the commercial sector has put some jobs at risk; therefore, those charities that see funding as a function of accounting numbers or funding being an assurance for job security and even bonuses for some colleagues have the motivation to window-dress numbers to fit the need.

The pressure or persuasion from fundraisers and commercial directors is likely to be an antecedent to manipulation of financial statement data; these groups may not always benefit instantly from such manipulation but there is strong evidence that the frontline personnel and their colleagues responsible for financial reporting see a causal effect which can be a potential motivator for accounting manipulation.

2.5.1.7 Professional reputation and career mobility

In order to judge a charity's success, the head of finance at a housing charity alluded to three perceptions or expectations by the *“external world”* for a charity to be *“financially secure”*, act *“within objectives”* and spend money where it *“should be spent” (ER2)*. Poor performance can have an adverse impact on reputation and career mobility of the non-profit sector managers including accountants. The sector which is supposed to enjoy its reputation as a flagbearer for noble causes and generosity is expected to attract individuals who are motivated by various factors other than purely financial ones, such as preserving and improving their personal reputation.

Talking about the fear of reputational damage of professionals by being associated with a failing charity, an interviewee recalled a conversation with a treasurer who had trained at a top 4 audit firm stating that their manager advised them to leave the charity because they *“could not afford to be seen ...part of an organisation that entered administration” (ER2)*.

A similar sentiment was echoed by an auditor who felt that at times an accountant who has not flagged certain deficiencies in the accounts in good time feels personally responsible for a less palatable final state of the accounts. This could act as a motivation to manipulate *“you don’t wanna look wrong do you that’s your job you should be all over the numbers...I mean is throughout the year if something was going wrong he should have flagged back to the audit committee but people don’t because they think it’s going to be ok .. you still feel like you failed so then you think people would judge you that you have not done any good job that it will”* (AUD2).

Some trustees may even encourage manipulation of accounting numbers as *“they don’t want to be seen to be failing”*. Trustees of relatively smaller charities *“could be local businessmen”* who would not want to be associated with a charity that is *“seen as doing badly”* (FR2).

2.5.1.8 Less sophisticated and incognizant users of financial statements

One recurring theme that emerged was the complexity that surrounds the charity sector accounting. Suppliers of services and even trustees and bankers are not fully familiarised with idiosyncrasies of this type of accounting. Evidence in the data suggests that charity financial statements are too complicated to comprehend by trustees and external suppliers of services alike. A surplus or deficit in charities is not as simplistic as an earnings figure in a corporation. Some interviews suggested that a deficit may be an act by choice to regulate the reserves levels. Likewise, a number of interviewees alluded to the fact that the unrestricted column in SoFA may have a surplus whereas restricted column may be showing a slight deficit and still the charity does reasonably well, as it is unrestricted income that eventually form the reserves. Most stakeholders other than charity accountants may find these intricacies difficult to understand.

One interviewee expressed their frustration that creditors and suppliers of various services may struggle to assess true financial stability or creditworthiness of a charity by simply employing the same yardstick as they would do in analysing viability within the commercial sector. In order to satisfy funding criteria or to appease trustees, a charity accountant may be content with showing a small surplus or at times even a slight deficit to regulate the levels of its reserves. Similarly in the years of higher

outgoings than incoming resources, there may be a temporary deficit which is normal for various charities because such a situation is reversed in a year when large income is received. This comment by an interviewee explains this problem *“Accounts that they may not look smooth due to large income in one year and expenses in another). At (Charity name) every other year I have a really big annual fundraising thing with (renowned celebrity) and I don’t know, that brings in £1 million. The year that you do it you’re £1 million up, and the year that you don’t you’re £1 million down, I think it takes 2 years to organise”* (ER2). This becomes problematic because various unsophisticated users would not understand this distinctive issue faced by charities. Suppliers of goods and services may be tentative to deal with an organisation with a negative bottom-line figure as they are likely to read financial statements in the same light as they would do for for-profit corporations. That is to say, most suppliers of services are likely to have a disproportionately larger number of commercial sector debtors; hence there is a possibility that they may not have the required expertise to analyse the peculiar accounts of a charity. Another interviewee said, *“The people that use (accounts), who may look at other companies’ accounts, even our bank manager I have to explain to our bank manager sometimes”* (ER2). It may even be challenging to decipher the wisdom and motives for certain levels of surplus or deficit, let alone getting to grips with restricted and unrestricted columns. Suppliers *“would not want to see a deficit”* (FR3). Similarly, the complexity of accounts can genuinely mystify and intimidate otherwise intelligent people too.

The data also suggests that a large number of trustees are also unable to fully comprehend the peculiarities of charity accounting. A respondent said *“...these charity accounts are for use with people who sell us phones or with internet provider or with our funders and with our trustees and our staff and they don’t get it, and our trustees are quite intelligent people, they’re high-powered in terms of people, and they don’t get it. The only people who get it are people who are charity accountants and that’s stupid”* (FR2). I posit that these factors also incentivise charity accountants to present financial statements in a way that draws minimal questioning and time wastage in explaining to various users of financial statements. The auditors in the sample mentioned financial instruments and holiday pay accruals as some of the examples where things have become rather complex even for the qualified charity accountants.

2.5.1.9 Income and expense period mismatch

The SORP has undergone significant development over the course of the last three decades.⁴² Even recently, there has been considerable development in line with financial reporting standards. In line with overall International Financial Reporting Standards, there have been some considerable changes in SORP (in line with FRS 102) such as revenue recognition, holiday pay accruals and other charity accounting specific areas. On the one hand, these changes are useful in improving consistency in reporting amongst various charities and *“got greater disclosure and there is some more information on support costs and governance costs” (ER2)*, but on the other hand various charity accountants believe that these changes have adversely affected their accounts and certain numbers do not represent the true position of their underlying economics. Some interviewees questioned whether the accruals concept was being breached in any way *“FRS 102 has completely thrown all of this lot out the water....because you have to recognise income much earlier than you would ever have done and the matching concept as far as I can work out has gone” (ER3)*. Another interviewee from a large international charity said: *“the world of the new SORP and FRS, it has been a challenge to understand changes.”* For instance, income recognition criteria are based on *“probability”* and not *“certainty”* now. (FR1).

Participants believed that charities' income is now likely to be recognised less prudently than before e.g. *“We are quite conservative but actually the SORP is actually leading to an encouragement to maybe an earlier recognition.”* Another comment confirms the mismatch between income and expenses as *“the way you recognise income and expenditure can often mean that they don't match” (FR3)*. I believe that as a consequence, there is motivation to either over-accrue future expenses in the interest of income smoothing or bring forward certain expenses that were needed in the future. This is because most organisations including charities would like to disclose smooth income. One interviewee commented *“you'll look like you've got a big surplus one year and then it will look like you've got lots of deficits following on from that” (ER3)*, and further expressed concern by saying *“there's a perception for the external people that deficits are bad and surpluses are good” (ER3)*.

⁴² There have been periodic developments to improve Charity SORP since 1988 when this first was introduced. Subsequent refined versions were introduced in 1995, 2000, 2005 and now Charity SORP in line with FRS102 which has been in effect from 1st January 2015.

The matching principle is at the heart of the accruals concept in accounting where income and expenses are recognised within the period to which they belong and not necessarily when the cash is paid or received, for the incurred expenses and earned income respectively. One interviewee remarked *"I think I've had to recognise £5 million in this year that I really wouldn't have from an accounting perspective because it's something that's going to happen over 4 years but for me, it looks wrong"* (ER3). Another interviewee commented that what you accrue for *"is an art, not a science"* (ER2). There are several examples of interviewees' disquiet over the period mismatch between income and its related expenses. If in one year their income became large due to early recognition and corresponding expenses were relatively minor this could theoretically motivate charities to manipulate SoFA by smoothing the bottom line figure. Interviews suggested that there exists motivation to either delay income or front-load expenses. I posit that in periods where large sums are expected through legacy or other forms of income such motivations would be pronounced. So it is a paradox that although the recent development in accounting standards and SORP is to discourage excessive and selective prudence, it has a tendency to undermine the accruals concept and therefore it can potentially incentivise accountants to manipulate using other means to smooth their income. Some interviewees suggested that the solution for such complexities is to have SORPs that are relevant to individual charity sub-groups whilst some agreed that it may not be a feasible undertaking by the Regulator. A charity under new rules is required to recognise income earlier in a year and then there is a likelihood that its corresponding expenses may straddle between periods. I postulate that the changes in the SORP, on the one hand, improve reporting quality by presenting the true state of the movement in charity funds but on the other hand, they pose problems for those charities in which the timing of income stream could be inconsistent. Such charities are more likely to be incentivised to smooth their earnings.

Legacy income has been affected specifically by the changes in income recognition guidance. As the amounts are usually large for legacy income, in the following year the charity's income could show a steep decline, particularly if a comparably large income is absent. While the criteria of income recognition are in the right direction for ensuring consistency between charities, those charities whose SoFA will show volatile performance over the years may have the motivation to smooth their income.

2.5.2 Misreporting facilitators

In addition to motives extant nonprofit research highlights opportunities to misreport financial information to mislead stakeholders or influence contractual outcomes (Hofmann and McSwain, 2013). This unplanned theme of opportunities emerged in the interviews that there are various factors which present as opportunities to facilitate the fulfilment of the motives. The interviews pointed to some enablers that I call “facilitators.” These not direct motivators for misreporting, however, their presence can potentially increase the probability of turning motivation into action. Managers are more likely to manipulate accounting numbers if either the users cannot detect such manipulation or the cost to manipulate is lower than the benefit associated with it (Matsumoto, 2002). In addition to the motivations to manipulate accounting numbers identified in the analysis, some other factors were also highlighted in the interviews which I view as facilitators and they interact in the manipulation of financial reporting. These interacting terms can present the opportunities to make the objective of massaging the financial statements relatively easier. It is important to note that the presence of particular motivations is important for these elements to act as enablers.

2.5.2.1 Low audit quality

The extant research on manipulation in nonprofit organisations highlights the existence of opportunities to misreport financial information in order to mislead stakeholders or influence contractual outcomes (Hofmann and McSwain, 2013). This section presents a discussion of opportunities that emerged during the interviews that appear to facilitate the fulfilment of the motives. The interviews pointed to some enablers that I call “facilitators.” These not direct motivators for misreporting; however, their presence can potentially increase the probability of turning motivation into action. In addition to the motivations to manipulate accounting numbers identified in the analysis, some other factors were also highlighted in the interviews which I view as facilitators and they interact with the manipulation of financial reporting. These interacting terms can present the opportunities to make the objective of manipulating the financial statements relatively easier. It is important to note that the presence of particular motivations is important for these elements to act as enablers.

Incentives for financial statements manipulation are reinforced if the chance of their detection is low (Wayne et al., 1996). The need for monitoring may be more relevant for nonprofits than for for-profit firms because donors do not directly monitor the use of their funds and receive no direct benefit from their contributions (Tate 2007; Vermeer, 2008). In a concerning report about the audit quality in the sector, the Charity Commission has found in its review that almost half of UK charity sector independent statutory audits do not meet the required standard.⁴³

My research points to the possibility that a number of auditors may not be in a position to spend enough time in ensuring high-quality audits partially because the audit fees are lower in the sector compared to the commercial world. The top 5,000 charities marked a 2.5% increase in audit fees in 2015 which is the lowest increase over the previous four years according to a report by Charity Financials. Of the 934 auditing firms, 55% have only one charity client. Two-thirds of the charities' audit fees were either reduced or remained at the same level. An increase in audit fees was more prevalent in the larger charities.⁴⁴ The UK's largest charities spent over £72m on audit fees in 2018 and 43 per cent of charities have not changed their auditor in the last decade (Charity Financials report).⁴⁵

Although it is not the scope of this research it is worth noting that auditors with relatively smaller charity clients are faced with increased competition as the statutory audit threshold has been raised from £500,000 to £1m since 31st March 2015,⁴⁶ which has spared over 4,000 charities from undertaking a statutory audit.

The limited amount of time and resources can make the detection of material misstatements challenging. In this regard, one interviewee stated, *"I don't know if it's even possible to audit in the timescales...what I ask auditors to do is nearly an impossible task."* Another interviewee said *"sometimes when they catch up they are here for 2 weeks and then at the end of 6 days they write we are done, we are off, you think: really? You are done?"* (ER1).

⁴³ <https://www.gov.uk/government/publications/accounts-monitoring-review-auditors-and-independent-examiners-compliance-with-their-responsibilities/auditors-and-independent-examiners-compliance-with-their-responsibilities>

⁴⁴ <http://www.charityfinancials.com/charity-financials-insider/top-uk-charities-spend-62m-of-charity-income-on-audit-fees-1439.html>

⁴⁵ <https://www.ft.com/content/44e78d4e-c998-11e9-af46-b09e8bfe60c0>

⁴⁶ The Charity Commission, 2019 audit quality review - <https://www.gov.uk/government/news/changes-to-audit-thresholds-to-help-charities-come-into-force>

Auditors may also be reluctant to ask difficult questions to their clients in order to save time and possibly even to avoid the embarrassment of not understanding the operations and controls in the short time that they can afford to allocate on the field. One interviewee even questioned the competence of auditors vis-a-vis complex transactions *“...around the more complex areas so stock being one of them and deferred income I think it is dead easy something that auditors don’t understand it and on mergers and acquisitions auditors’ understanding of even the journal entries is totally appalling”* (ER1).

One sub-theme that emerged through experiences of several interviewees was the rarity of the audit adjustments demanded by the statutory auditors. The head of finance for an international charity said: *“I was surprised that there were so few adjustments identified by our auditors”* (FR1). Another comment succinctly expressed *“across the board the quality of audits is not high and actually I don’t know if it’s even possible to audit in the timescales”*(ER1). One interviewee who was an accountant at a charity in London before joining another charity in a relatively smaller city revealed that the audit quality even from a regional office of a top 4 audit firm “appalled” them compared to what they experienced in London. I conclude that inferior audit quality is an opportunity which can encourage those individuals and charities that are more prone to manipulating. I could, therefore, have also included this as a main motivation but it is included in catalytic factors because only those accountants who are already motivated to manipulate will find the courage to exploit low audit quality.

I took the perspective of auditors on this too; in contrast to some charity accountants’ perception that auditors do not spend enough time on the audits, auditors articulated that they were aware of some of the inherent risks associated with auditing charities as well as predispositions due to firm-specific risks and their audit approach is designed accordingly.

Given the complexity of charity accounting, a vigorous approach may not be as economically viable as in the case of profit-making organisations. I note that auditors are aware of the challenges faced in auditing the sector. Referring to smaller charities, one auditor agreed that *“they might not have the time or enough people or experience and expertise to prepare and maintain financial records and keep them up to date, the level of quality that really is needed.”* AUD1. There are other challenges in auditing

larger charities where it is *“difficult to make sense sometimes or to gain a more detailed understanding of the financial information they give you to audit”* (AUD1). This does however somewhat endorse what a charity accountant called “embarrassment” on auditor’s part to ask questions. Extant literature supports that proxies of audit quality such as audit size and audit committee have a positive impact on the expense classification accuracy (e.g. Harris et al., 2015). Charities are reported to have almost double the number of financial reporting errors that their similar-sized corporate counterparts have, while the Big 4 and second-tier auditors reduce the rate of misreporting (Burks et al., 2015). The lower audit quality is expected to be because of reduced litigation risk to nonprofit organisations’ auditors (Beattie et al. 2001; Vermeer 2008; Lopez and Peters 2010) in the absence of personal loss of contributors⁴⁷.

2.5.2.2 Trustees’ ineptitude

This study finds evidence that the trustees’ role in accounting numbers varies depending on their qualifications, experience, and size of the charities that they are associated with. Those trustees who are not versed with recommended practices or relevant reporting standards to treat certain accounting transactions may have unreasonable expectations from the accountants to show certain numbers in a particular way, giving less thought to the binding accounting treatment. There are cases where they even compel accountants to aim for certain numbers. A lack of independence can adversely affect the likelihood of manipulation. On the contrary, their role demands them to assertively question and challenge the accounting numbers in order for them to give a true and fair view.

There is an impression about some trustees amongst accountants that they do not *“understand financial management”* and they are *“embarrassed that they don’t know or understand things.”* Another interviewee commented that they *“do not really understand the nitty-gritty of the accounting needs.”* (ER1).

When asked whether, in periods of financial distress, there is a possibility of manipulation, one interviewee responded: *“depends on the trustees and how competent they are; because I’ve been with trustees who just really care about what they (financial statements) look like.”* Regarding the trustees of financially distressed charities one interviewee said *“(they) may be more manipulative I’ve found”* (FR2).

⁴⁷<https://www.ft.com/content/44e78d4e-c998-11e9-af46-b09e8bfe60c0>

On the contrary, trustees are cognizant of certain “acceptable” norms and conventions. In certain cases, trustees are expected to influence accountants in pursuit of conforming to such financial statements’ ‘norms’; for instance they *“always check what the ratio is for the fundraising costs to fundraising expenditure”* (FR2). Another head of finance at a nationally renowned fundraising charity said: *“our Trustees here have chosen 35% (for fundraising costs) but that is completely finger in the air”* (FR3).

When asked what may motivate an accountant to manipulate accounting numbers one finance director unambiguously said *“to pull the wool over donor’s eyes, (and) to satisfy trustees”* There is also a feeling that some trustees are not even interested in financial statements as they *“care about the front bit”* of the annual report; referring to just the narrative reports (ER1).

This finding is in line with the extant literature, for example that asset misappropriation, a form of manipulation, is negatively associated with the independence of key individuals (Harris, 2017). Jonathan Orchard, partner at Sayer Vincent, Charity Accountants has openly suggested that charities might be more susceptible to internal fraud than private-sector firms because of being less likely to have a financially literate chief executive, who may not be asking their finance directors the right questions.⁴⁸ The data also suggests that the frequency of the trustees’ meetings and discussion on financial statements varied significantly but I was not able to find unique patterns in relation to income types or sub-groups.

2.5.2.3 Unsophisticated funders

The extant literature in the for-profit landscape investigates vertical classification shifting (e.g. McVay, 2006). I am intrigued to understand whether charities are motivated to “manage” restricted and unrestricted income and expenses by exercising horizontal classification shifting. The literature has been silent on whether charities are motivated to shift between the columns (such as restricted, unrestricted and designated).

A senior audit manager when asked about this potential misclassification responded by saying *“Yes there could be incentives definitely. It could be difficult to I think to get away with it just because a funder for restricted purposes can often ask a charity to*

⁴⁸ <https://www.civilsociety.co.uk/news/fraud-costs-charities-over-2-5bn-a-year.html#sthash.tF8MmmkH.dpuf>

report back to them how they've spent the funds." AUD1. This response can be interpreted in various ways. A charity is motivated to misclassify between columns and it is only deterred for the fear of being caught. It may not, therefore, be a farfetched assumption that unsophisticated and individual donors may be less likely to dissect through the numbers in comparison to large donors such as trusts and foundations. Furthermore, there is evidence of vertical misclassification between expenses in the same column. Those charities that have a large number of permanent staff would face a bigger pressure to curtail costs. *"It's difficult to fire staff and can be expensive with redundancy costs and claims and so on...the pressure would be to allocate as much as possible (to charitable activities)"* (FR5). Therefore, the pressures seem to lead to misclassification of fundraising costs as expenses spent on charitable activities.

With less sophisticated donors, it is not expected that they would scrutinise the financial statements; instead, it is the media that charities try to avoid by adhering to certain "acceptable" benchmarks as one interviewee said *"every now and again there will be a series of stories that hit the news, the headlines, where people are talking about how expensive charities are and that ratio, for every pound raised, how much of it did you spend on fundraising or how you choose to interpret it"* (FR3).

For a fundraising charity that collects small donations from a large number of donors, as long as adverse media attention is warded off *"I would say it's much easier because you know this might sound quite cynical but then the level of post donations scrutiny probably isn't as hard...they are not saying well I gave you I gave you 10 quid a month so show me exactly how you spend my 10 quid"* (ER2). Regarding this low scrutiny from small donors, a comment from another interviewee provides evidence that the fundraising charities would find it easier to misclassify between restricted and unrestricted columns as they would prefer to have a larger "free" income *"I just think sometimes that a project is restricted but actually people perceive it as being unrestricted because maybe the donor is not as involved in it as you would perceive within a more restricted project"*. Conversely, sophisticated funders would scrutinise the financial statements in-depth and in certain cases would demand *"assurance reports"* which are provided by auditors. Both finance directors and auditors discussed these reports in the interview. I, therefore, argue that fundraising charities collecting their income from a large number of small donors would seek to "legitimise" their existence by presenting "acceptable" numbers. I posit that for a fundraising charity

with a large number of unsophisticated donors, on the one hand, their accounts are relevant for (a superficial) media scrutiny but at the same time dispersed donors would not demand a detailed account of columnar and horizontal classifications. Whilst giving an example of a well-known fundraising charity, a senior charity accountant commented: *“you may well have people looking at their accounts and there will be commentators in the press making their observations about how they run their charity and therefore the accounts do matter a lot more”* (ER5).

2.6 Conclusion

This study has confirmed various theoretical assertions in relation to motivations for financial misreporting in a charity setting. Employing semi-structured interviews, this study is the first to my knowledge in examining financial misreporting in the setting of charity accounting research.

In-depth semi-structured interviews helped to develop a better understanding of motivators for accounting manipulation that confirmed several concepts in the extant literature as well as adding new observations. It appears that, for charities, the prime motive remains the continuance of financial support through signalling conformity to the ‘norms’ of acceptable behaviour for long-term survival (Dowling and Pfeffer, 1975) as the survival of an organisation depends on acquiring and maintaining its resources (Pfeffer and Salancik 1978). Charities use levels of income, expenses and reserves as tools to convince donors of their legitimacy.

My study reveals that charities are faced with competing pressures to manipulate its financial reports. Furthermore, each incentive in its own right may lead to a certain course of action which may not amount to true and fair accounting. The interviews support the assertion considering various theoretical frameworks such as resource dependency, legitimacy, and agency theories, that large UK charities do indeed face pressures and motivations for misreporting their accounting numbers. I highlight three major areas of financial reporting mis-statements namely expense misclassifications, funds misclassification and the bottom line surplus/deficit misreporting. Most large charities receive a mix of income resources, and therefore financial reporting choices may face complex pressures. For simplicity, I separate the charities into two broad categories, namely fundraising and earning.

The indispensable need for a charity is that the sources of its funding stay intact and it remains financially sustainable so that it carries on achieving its objectives for which it exists. Various determinants make the situation uncertain, hence motivate financial statements' misreporting. A charity with high levels of reserves may suffer with crowding-out (e.g. Abrams and Schmitz, 1978, 1984; Daws and Thaler, 1988) because it is viewed as self-sufficient by donors. The Charity Commission is also currently recommending charities to use their reserves in these times of crisis. However a quarter of the charities only have reserves that would last for three months. Half of the charities can survive without further income for just over six months.⁴⁹

Rising overheads, especially in London due to competitive staff wages and redundancy costs, can challenge management with difficult financial reporting decisions. Charities are expected to avoid allocating a large part to fundraising expenses, hence increasing the likelihood that they would subjectively misallocate most costs as charitable activities expense. Less sophisticated users of financial statements e.g. suppliers of goods and services may view a charity's financial statements in the same light as users of for-profit firms' financial statements will. This contributes to a complex mix of challenges in financial reporting choices. Similarly, an increasing trend from voluntary to more earned income poses intricate challenges for charities to appear financially viable, while appearing legitimate to keep private donors conciliated. The legitimacy pressures are further exacerbated if charities in the same sub-group exhibit more "acceptable" numbers in their financial statements, as my interviews confirm that peer benchmarking is a general practice in the sector. This is extensively reported in the literature covering for-profit industries. Agency theory also appears to be at play, for instance the indebted charities are expected to have covenants linked to their financial statements. Although my interviews do not confirm whether charities manipulate their financial statements in response to this particular pressure, there is a possibility that debt covenants are a relevant factor in influencing the financial reporting quality. Future research in this area is invited to elucidate the impact of this pressure. I also find that the career aspirations of personnel of the charities as well as their job security add to pressures for manipulation for the ultimate goal of securing the charity's future funding. The income/expense period mismatch is

⁴⁹ https://www.gov.uk/guidance/manage-financial-difficulties-in-your-charity-caused-by-coronavirus?utm_source=45cb232f-bbd7-4f60-8b8c-7a060951e45a&utm_medium=email&utm_campaign=govuk-notifications&utm_content=immediate

another factor that perplexes managers as that results in an apparently erratic financial performance, something that incognizant users of financial statements would view unfavourably.

I identify three facilitators or catalytic aspects that increase the probability of financial misreporting. Generally it appears from the data that the audit quality in charities is inferior to their for-profit counterparts. Given that charities do not operate in financial markets, one would expect the need for a superior audit quality due to increased information asymmetry (Kitching, 2009) with less monitors. Inexperienced or less qualified trustees are more likely to turn a blind eye at best, and instigate financial misreporting at worst. Charities with donors from the general public, who do not keep tabs on their funds, are expected to have a freer hand in misreporting their financial statements.

The expectations for a charity by donors and monitoring agencies could be unintended and unreasonable and can put pressures on charities to present low-quality financial reporting (Tinkleman, 2009). The role of auditors appears inconsistent and there is a research gap in fully understanding the level of their training and the level of subjectivity that may be acceptable. The question of materiality in joint cost allocation is an important one (Tinkleman, 2009) and my interviews show that there are significant inconsistencies and variabilities in audit quality and auditor's attitudes towards the level of subjectivity.

I find that low levels of fundraising costs are in the interest of all types of charities. This can prove quite a conundrum; where on the one hand the charities need to spend for raising funds to remain competitive; on the other, they may be compelled to cover-up even justifiable costs to appease the funders. Similarly, in order to satiate resource dependency, they would need an acceptable level of reserves as a provision for rainy days, yet they may succumb to the dependency pressure and deliberately deplete the reserves to preserve legitimacy in the eyes of stakeholders.

In most charities, the pressure to regulate reserves seems prevalent. Whilst fundraising charities may have incentives to regulate reserves downwards in some cases, those earning charities that are awarded large contracts may prefer comparatively healthier reserves to show financial viability. The quest for reducing reserves may lead to inefficient use of resources. I suspect that the main focus of

some charities may become the pursuit for reserves depletion, and not necessarily the consideration whether there is a legitimate necessity for a certain level of expenditure, or indeed if there is a genuine case to reduce the reserves at all. In the short-term, depleting reserves may come at a cost of the long-term sustainability and perpetuation of a charity. Supposedly, reserves can be reduced in mainly two ways; either by decreasing income or increasing expenditure. I note that in the interest of a fairer distribution of limited donors' resources, it may be rational to expect a charity with high reserves to halt its fundraising so that new funding could be directed to more deserving charities, but in practice adjustments to reserves' policies, accounting manipulation or inefficient spending are amongst the possible responses.

Furthermore, certain charities may have incentives to appear "financially viable" via healthy reserves and unrestricted surplus. In order to appear financially viable sustained deficits are likely to be avoided. On the contrary, the bottom-line surpluses (net incoming resources) are expected to be sustained by such charities to bolster their unrestricted reserves. Charities need to regulate reserves at levels that are neither too high (inviting dissatisfaction of the funders) nor too low that the charity faces challenges to its going concern position.

There may be years when there are higher incoming over outgoing resources such as through large one-off bequest receipts or significant income through grand fundraising events. This may create a curious accruals mismatch causing a temporary large surplus, motivating charities to smooth the bottom line downwards by either recording expenses too early or simply spending inefficiently and extravagantly on ill-considered projects in the current year. In the years when such one-off income is absent, charities may be tempted to defer expenses or accrue income too early to turn a large deficit to a small surplus.

I further discover another response to resource dependency pressures that the extant literature largely ignores. I call it "horizontal misclassification," alluding to unrestricted expenses misclassified as restricted expenses. This is a serious breach of the relevant accounting standard, SORP 2015. This expense shifting, referred to as 'cross-contamination' by an interviewee can be used to a) bolster levels of free reserves and b) turn an unrestricted deficit into a surplus.

I also find that debt covenants could be linked to charities' reserves. This is another area which to my knowledge has not been identified before. Therefore, I expect the indebted charities may be interested in presenting a higher level of reserves.

Comparing bottom-line surplus/deficit with competitors appears a factor which could potentially be a motive in managing earnings to a legitimate level, something which can be investigated in future research. I also gather from the interviews that to report deficits, fundraising ratios should possibly be kept low enough to ward off criticism citing poor financial management by trustees.

Overall, there is a clear need to educate charity accountants, trustees and most importantly the donors to not treat certain numbers simplistically. If there remains a common perception of what is and is not a legitimate or acceptable number or ratio, charity accountants would keep facing pressures to manipulate certain figures, and in doing so they would not only misguide the grantors in the allocation of limited resources but also indulge in expending funds inefficiently, such as by spending too early to regulate the bottom line in the years of abundance and delay expenditures in the years of austerity. This would nurture an inefficient system and an already growing trust deficit in the sector would only worsen; something that is in none of the stakeholders' interest.

There may be a case for the Charity Commission to consider certain modifications to SORP that can cater to different charity sub-groups. This may not be a feasible option for a very complex sector with several sub-groups but further research can point to the right direction in gathering similar sub-groups which can be catered for with similar guidelines in addition to the SORPs.

This study has its inherent limitations. Firstly, the charity sector is very complex and varied in the UK and with the given time and resources it is not feasible to carry out in-depth semi-structured interviews with a large sample within each of the charity sub-groups. This research has however included accountants from charities that collectively cover all major sources of UK charity income. Similarly, the response rate has been very low. It is also recognised by the author that if a low response rate indicates some kind of response bias where the respondents differ in a meaningful way from the non-respondents, then there may be a theme that this study has not managed to capture.

This study is a vital addition to the scant academic literature on financial misreporting in the charity sector in the UK. Earnings management in nonprofit hospitals has been the focus of prior literature. To my knowledge, this is the first study that involves in-depth examination of the behaviour of UK charity sector organisations in England and Wales to establish whether managers of these charities manipulate earnings and practise expense classification shifting in their financial statements through the use of a less used method, which strengthens the existing theory. As this study covers all commonly known aspects of financial misreporting by charities it is a useful response to the calls by the Charity Commission that auditors of the UK charities are “letting down” their profession and only half of a sample of charity accounts met the required standards in 2017.⁵⁰ Hence it has policy implications as well as a reminder for the audit profession that the quality of audit needs to be even more rigorous than corporations due to a reduced level of monitoring. This study also reminds the public that charities are motivated to misreport in their financial statements to avoid criticism. Hence it informs sophisticated as well as disparate individual donors to be more informed of their chosen charities through various financial and non-financial means. This study is also a very timely response to the concerns by the regulator and media about the dwindling confidence in the sector; the financial reporting related misgivings remind us of “The numbers game” (Levitt, 1998) that preceded high profile corporate scandals. This study has practical implications for the accounting profession, regulators, charities and funders to tighten the loose ends that have a potential to contribute to catastrophes with serious implications for public trust and the future of a very important sector in the economy.

Future research in this area can make a useful contribution to the positive accounting theory to predict management behaviour in the UK charity accounting setting. This will assist the charity regulator in utilising its limited resources by focusing its random inquiries in the right direction and developing SORPs that cater for individual sub-sectors; so that their financial statements portray their true position and are comprehensible to the average primary user. Most importantly, a better understanding of such motives can guide donors in making more informed and economically rational funding decisions.

⁵⁰ <https://www.gov.uk/government/publications/accounts-monitoring-review-auditors-and-independent-examiners-compliance-with-their-responsibilities/auditors-and-independent-examiners-compliance-with-their-responsibilities>

Appendix 2.1: Interview questions guide

The list of questions below are those that were asked of the heads of finance. The auditors and banker were asked similar questions but targeted towards their experience with charities.

- Please provide some brief details of your current role
- Briefly state your qualifications and previous roles in your career
- Who are the main funders of your charity?
- In your opinion, which numbers in your financial statements may interest your funders?
- How do these numbers, if at all, influence your funders?
- What do your funders look for in the SoFA and Balance Sheet in order to renew their donations and/or contracts?
- What are the greatest challenges faced by a charity like yours concerning financial reporting?
- Are there any ideal ratios or numbers in the financial statements that you aspire to achieve?
- Are there any particular financial reporting pressures that you are faced with?
- Do you face any pressures from trustees or anybody within the organisation regarding some financial reporting figures?
- What is the most desirable position in the SoFA: a large deficit, a small deficit, breakeven, a small surplus or a large surplus? And why?
- What is the ideal level of reserves that may look good in your financial statements?
- Have there been any major audit adjustments required by your auditors since you assumed the current role as the head of Finance?
- With regards to your reserves policy, if you do not meet the targets set by trustees (or others) then what pressures do you face?
- Is management compensation ever linked to the financial performance of a charity?
- Is misclassification between restricted and unrestricted income and expenses possible?

Chapter 3: Study on Accruals-based and Real Activities Earnings Management by UK Charities

3.1 Introduction

The government's inability to meet the demand for public goods in populations with heterogeneous preferences leads to the need for nonprofit organisations (e.g. Weisbrod, 1977; Weisbrod, 2009). Therefore, governments support charities as they reduce the burden on state funds (Salamon, 1990; Mayer & Wilson, 2010; Hyndman & McMahon, 2011). Charities earning over £5 million account for only 1.3% of the total number of charities in the UK (2,263 out of some 168,000 charities) but they account for over 72% (over £55bn of £77bn) of total income generated by the charitable sector. Where almost a billion individuals volunteer globally (Salamon et al., 2011), one in four adults donate to the sector in the UK and amongst them young adults volunteer the most (UK Parliament research briefing, 2017).⁵¹ Although, the scale of social and economic value added by the sector may not be fully quantifiable, with the help of a large “volunteers army”, 1.25 million full-time employees create economic value above £50bn annually.⁵² To put this into perspective, charities fund almost half of all medical research in the UK.⁵³

Because of the economic and social significance of the sector, it is important that it remains transparent. However, the confidence level in the sector has been low and according to the Charity Commission's head of the accountancy services “*the deterioration in the quality of accounts is of serious concern.*”⁵⁴ Since there is a large public stake in nonprofits or not-for-profit organisations, it is important that their accounting is trustworthy. Agency problems could contribute to accounting manipulation in charities which can impact negatively on welfare (Jegers, 2010). There is evidence, albeit much limited compared to for-profit firms, that managers of nonprofits opportunistically misreport the accounting numbers that may influence the level of private donations or government funding (e.g. Bouwens et al., 2004; Leone &

⁵¹Community Life Survey data for 2015/16 shows that 73% of adults in England had given to charity in the four weeks prior to survey.

⁵² In giving, how much do we receive? The social value of volunteering. Speech given by Andrew G Haldane, Chief Economist, Bank of England. A Pro Bono Economics lecture to the Society of Business Economists, London 9 September 2014.

⁵³Association of Medical Research Charities: “*The charities' combined research spend makes up nearly half (47%) of publicly funded medical research*”

<https://www.amrc.org.uk/news/uk-charities-research-funding-remains-stable-despite-tough-environment>

⁵⁴GOV.UK - Regulator finds quality and transparency in charity accounts has fallen.

<https://www.gov.uk/government/news/regulator-finds-quality-and-transparency-in-charity-accounts-has-fallen>

Van Horn, 2005; Ballantine et al., 2007; Verbruggen and Christiaens, 2012; Yetman & Yetman, 2012; Balsam and Harris, 2013; Ferreira, 2013; Greenwood et al., 2017; Beck, 2018). Research on earnings manipulation in nonprofits is predominantly focused on nonprofit hospitals. Only a small number of studies focus on the charity sector as a whole. Given the importance of the sector and the potential impact of misreporting on resource allocation, this study investigates this issue in UK charities, focusing on how funders' sophistication and donor-beneficiary separation affect earnings management behaviour.

There are several stakeholders of a charity such as the users of its services, donors, lenders, and the regulator. Many of these stakeholders expect nonprofits to break-even and therefore report a zero-profit figure in their financial statements. The violation of the zero-profit constraint increases the likelihood of CEO termination (e.g. in nonprofit hospitals in Leone and Van Horn 2005). A large surplus implies that the nonprofit is not fulfilling its charitable purpose and a deficit would be equally undesirable, casting doubt over management's ability to sustain a nonprofit as a going concern. Similarly, an indebted nonprofit's deficit could increase the cost of debt, or damage its reputation in the eyes of the subsidising government, affecting the number of services (Leone & Van Horn, 2005; Jones & Roberts, 2006; Ballantine et al., 2007; Verbruggen and Christiaens, 2012). This leads to an inherent need for a bottom line earnings figure which is around zero. Furthermore, a significant number of nonprofits maintain very little reserves because charities discount the benefits of reserves as they are possibly evaluated on spending (Calabrese, 2013). As surplus/deficit end up in the reserves, large surpluses would, therefore, lead to large reserves. This may attract undue attention, leading to reduced funding owing to the assertion that the charity has sufficient funds and does not need more.

Following limited previous studies that firms use multiple earnings management strategies (e.g. Leone et al. 2005; Cohen and Zarowin, 2010; Zang 2012), I study whether UK charities resort to accrual and real-based earnings management activities to report bottom-line earnings that are around a zero surplus/deficit. Using an initial sample of more than 103,000 nonprofit firm-year observations, I find that nonprofits drive their results towards a target range of a small surplus. Consistent with prior literature (e.g. Yetman & Yetman, 2012; Balsam and Harris, 2013) accounting manipulation is observed more in the charities that are funded by less sophisticated

funders. Therefore, charities that are funded by more sophisticated funders tend to manipulate less towards a target range, hence confirming that they are aware that such practice would be counterproductive to their future donations. Furthermore, while Parsons et al. (2017) do not find that donor restriction affects earnings manipulation, my results suggest that donor restriction does reduce the level of managing bottom-line earnings.

I also find that charities have preferences of different earnings management types, depending on the level of their programme revenue. I find that the accruals-based manipulation is exacerbated by more service-oriented charities (i.e. nonprofits with higher than median programme revenue). On the contrary, real activities management is higher in more charitable nonprofits (i.e. those with lower than median programme revenue). Therefore, pressure to manipulate earnings is more likely through the costlier form of earnings management i.e. real activities earnings management.

The results of the current study provide a significant contribution to the nonprofit accounting literature, which has a limited number of studies on the charity sector's earnings quality. To my knowledge, there have been no studies that separately investigate the earnings management approaches between more service-oriented charities and their charitable nonprofit counterparts. Furthermore, prior literature finds that more sophisticated funders discount poor quality financial statements (e.g. Yetman & Yetman, 2012; Balsam and Harris, 2013) or goes as far as suggesting that sophisticated managers of a nonprofit are less likely to manipulate earnings, but does not investigate the impact of sophistication on nonprofit management's behaviour towards manipulation. I use two measures to investigate sophistication of funders and find similar results (ratio of restricted funds and ratio endowment funds).

This study has societal relevance as it boosts confidence in earnings quality of the charities funded by donors that are more sophisticated: those that place restrictions on the use of their donations. Whereas prior research points to the preference for accrual-based earnings management due to their lower reversal costs than making real decisions vis-à-vis operational costs (Peasnell, 1998; Pilcher and Van der Zhan, 2010), in this study, I show that charities are interested in accruals-based earnings management to preserve their "real" level of services.

The remainder of the study is organised as follows. The next section discusses the literature and develops the hypotheses of the study. This is followed by a discussion of the sample of variables used. In the next section, I present the results of the study, followed by a conclusion and discussion of limitations and future research.

3.2 Literature review and hypotheses development

Resource dependency theory (hereafter, RDT) explains that organisational actions have societal acceptance rather than economic performance as an underlying motive (Drees & Heugens, 2013). This theory postulates that an organisation devises its operating strategy according to the expectations and preferences of its resource providers (Pfeffer & Salancik, 1978; Drees & Heugens, 2013; Parsons, 2017). Variations in financial reporting quality could undermine both regulatory effectiveness and resource allocation (Greenwood et al., 2017). RDT suggests that funding sources are associated with varying levels of oversight. Recognising these levels, the managers must respond to every key resource provider's demands to sustain continued funding (Ling and Roberts, 2017). Therefore, the information contained in financial statements can be aimed at responding to resource dependency pressures and that sometimes can come at the cost of true and fair reporting.

Theoretical and anecdotal evidence presented in the literature finds a preference for managers of firms to report profits compared to losses. Individuals are more averse to losses than to an equivalent amount of profits (Kahneman and Tversky, 1979, 2013). This can be extended to the preference for managers of firms to avoid reporting losses in favour of profits or a breakeven point i.e. zero bottom-line earnings (Leone and Van Horne, 2005). Alternatively, managers can opportunistically use reporting discretion to achieve certain objectives for cost purposes (Watts and Zimmerman, 1990). In this regard, a firm that reports a loss may face higher transaction costs with stakeholders than firms reporting a profit. Therefore, a firm may decide to avoid losses to decrease the transaction costs with its stakeholders (Burgstahler and Dichev, 1997). Also, small losses may harm a CEO's reputation and therefore managers are more likely to aim for small profits (Leone and Van Horne, 2005).

Although the above applies to the for-profit sector, managers of charities arguably have similar preferences. Based on prospect theory, the cost to a nonprofit of reporting a £1 loss will be larger than the cost of reporting a £1 profit. However, reporting a

surplus can also come with transactional costs in the form of increased scrutiny (Eldenburg et al., 2011). An excessive level of surplus may suggest that the charity has exhausted its philanthropic activities, delayed these to a future period, or not exerted sufficient effort to identify worthy projects (Leone and Van Horn 2005). On the other hand, if a charity suffers sustained deficits, this would lead to the depletion of its reserves making it appear less sustainable and therefore casting doubts over its ability to fulfil its mission. This could lead to going concern issues which would inevitably concern the relevant internal and external stakeholders, such as contract commissioners and funders with a vision for impact. Although some nonprofit sectors such as the UK National Health Service (NHS) Trust hospitals have a regulatory duty to deliver zero bottom-line earnings (Ballantine et al., 2007), there is currently no such regulatory obligation for charities. In the nonprofit context, prior research confirms that donors consider earnings in deciding on the level of current or future donations. They are found less likely to donate money to those nonprofits that return high levels of surpluses (e.g. Leone and Van Horn, 2005; Bouwens et al., 2006; Ballantine et al., 2007; Verbruggen and Christiaens 2012; Ferreira et al., 2013; Jegers, 2013; Arcas and Marti, 2016).

Managers are known to use both accrual earnings management (hereafter, AEM) and real activities earnings management (hereafter, REM) to manage earnings towards a benchmark target or range. A target earnings benchmark (Burgstahler and Dichev 1997) has been studied extensively in for-profit firms. Most studies have focused on AEM (e.g. DeFond and Jambalvo, 1994; Peasnell et al., 1999; Cheng and Warfield, 2005; Bergstresser and Philippon, 2006; Gore et al., 2007; Cohen and Zarowin, 2010). However, there has been growing evidence that firms also engage in REM (e.g. Baber et al. 1991; Dechow and Sloan 1991; Bushee, 1998; Graham et al., 2005; Roychowdhury 2006; Cohen et al., 2008; Cohen and Zarowin 2010; Cheng et al., 2016). Empirical evidence finds that managers avoid reporting small deficits and manage earnings to report a small surplus in the for-profit sector (e.g. Burgstahler and Dichev, 1997; Dechow et al., 1999;).

Just as in for-profit sectors, there is evidence that managers manage earnings to report a small surplus in the nonprofit sector (e.g. Leone and Van Horn, 2005; Bouwens et al., 2006; Ballantine et al., 2007; Verbruggen and Christiaens 2012;

Ferreira et al., 2013; Jegers, 2013; Arcas and Marti, 2016; Beck, 2018). Again, most studies concentrate on accruals-based manipulation with a handful that investigates real earnings management (e.g. Leone and Van Horn, 2005). Arcas and Marti (2016) identify the incidence of abnormal earnings in pursuit of an earnings figure close to zero and in avoiding big deficits. Jegers (2013) in his study of 844 Belgian nonprofits' financial statements finds that debt and potential agency conflicts between board and management prompt accruals-based manipulation towards zero earnings. He also reports that larger nonprofits are more prone to reaching earnings benchmark through manipulation. Furthermore, Verbruggen and Christiaens (2012) explore the use of discretionary accruals and an unexpected level of depreciation by nonprofits in pursuit of government subsidies using the data of 925 nonprofits from the year 2006. They find that manipulation to push earnings towards the breakeven point is exacerbated when government funding is increased. Similarly, Ferreira et al. (2012) find that the Portuguese public sector also use discretionary accruals in a study of 1,453 firm years 2002 through 2008.

Studying panel data of 1,520 firm years of NHS hospital Trusts from 1998–2005, Ballantine (2007) discover the use of discretionary accruals to report earnings within the target range around zero. Stalebrink (2007) studies 288 Swedish municipalities between the years 2000 through 2004 indicating that municipalities increase write-off and depreciation expenses when large deficits are recorded for income smoothing or when there are large pre-discretion surpluses. Bouwens et al. (2004) find that Dutch nonprofit hospitals manage discretionary accruals upwards in the year before and within the year of new financial debt. Greenwood et al. (2017) in their study of 700 NHS Foundation Trusts over five years (2009–2014) report that despite a shift away from breakeven in profits, as the primary performance objective, there remains an aversion to reporting small deficits and preferring a small surplus.

Leone and Van Horn (2005), in their study of 8,179 hospital-year observations find the use of discretionary spending on charity care and discretionary accrual management. Similarly, Eldenburg et al. (2011) studying 432 nonprofit hospital years (1998–2003) in California find discretionary spending (non-operating and non-revenue- generating activities) is regulated to achieve a benchmark of zero profits. Hoerger (1991) using six years of panel data (1983-88) of over 15,000 hospital-years find that nonprofit

hospitals minimise the variance in reported earnings through real spending. In a study examining accrual manipulation in US municipalities, Beck (2018) suggests that creditors as “sophisticated users” increase the scrutiny of municipalities with questionable financial performance.

Although managers of nonprofits may ideally prefer an exact breakeven point, this may be a risky benchmark to target. Planning to achieve a small surplus can create a buffer for unforeseen circumstances that could push a breakeven position into a deficit (Leone and Van Horn, 2005). Since the objective of a nonprofit is to serve the purpose for which it exists and not make a profit for redistributing to shareholders, its funders would expect to see the earnings level around the zero benchmark. Whilst studying a large number of firm years it can, therefore, be expected that the earnings (surplus/deficit) distribution should be close to zero with a tendency towards a small surplus; this small surplus would assure the stakeholders of its financial viability.

Based on the above discussion, I present the first hypothesis below:

H1: Nonprofits are more likely to report a small surplus than a small deficit.

One way in which managers of firms can avoid reporting losses or an excessive surplus is through the use of accounting accruals. Several researchers have found that nonprofits manage earnings using discretionary accruals to achieve a small surplus (e.g. Leone and Horn, 2005; Ballantine et al., 2007; Ferreira et al., 2012). Managers can take advantage of the subjective nature of certain accounting standards to adjust reported earnings rather than increase or decrease real spending (Hoerger, 1991; Leone and Van Horne, 2005). Many studies find a negative association between discretionary accruals and pre-managed performance and find that discretionary accruals are managed to reduce both surplus and deficit (e.g. Leone and Van Horne, 2005; Ferreira et al., 2012; Verbruggen and Christiaens 2012).

Therefore, I expect a negative relationship between discretionary accruals and earnings before discretionary accruals. This expectation is founded on the assumption that the managers of a charity with a surplus will more likely exercise income-decreasing negative discretionary accruals. Likewise, managers of a charity with a deficit are more likely to exercise income-increasing positive discretionary accruals. Therefore, I formulate the second hypothesis as follows:

H2: There is a negative relationship between discretionary accruals and earnings before discretionary accruals in nonprofits.

The RDT posits that different funding sources lead to varying monitoring demands by the funders/donors (Pfeffer and Salancik, 1978; Gaver and Im, 2014). Therefore, it is expected that the ability to report a small surplus may not be comparable for charities with varying degrees of funder sophistication. The extant literature provides empirical evidence that the sophistication of funders has an impact on financial reporting quality of a nonprofit (Krishnan and Yetman, 2011; Balsam and Harris, 2014; Greenwood and Tao, 2016).

Earlier studies have considered a high proportion of restricted funds as an indicator of sophistication. More sophisticated donors are more likely to discount the impact of manipulation compared to their less sophisticated counterparts who are made up of disparate small donors (Yetman and Yetman, 2013). The reason for this is that smaller individual donors do not generally seek detailed information directly. Also, they may not have the necessary skills to unpick the intricate details of the accounting data. A large number of small donors may not know where to find the relevant information in the financial reports (Tinkelman 1998; Yetman and Yetman 2013). On the contrary, sophisticated funders/donors are expected to better comprehend a complicated set of financial information. Similarly, they would be more interested in monitoring, with the intent to assess whether their restricted funds are being used for the stipulated purposes. Restrictions on the use of donations impose direct control over the spending of resources by a nonprofit (Loftin, 1998; Silverman & Beatty, 2006; Parsons et al., 2017).

Parsons et al.'s (2017) survey of 200 nonprofits (2006 to 2008) shows that charities that face pressures to manage their ratios are less likely to do so when there are monitors and sophisticated managers. Information asymmetry between a nonprofit and those monitoring and evaluating its performance is often low (Greenwood et al., 2017). In their event-study approach, Balsam and Harris (2014) find that sophisticated donors look at more complex forms of information in the financial statements whereas small donors tend to rely on media reports. Yetman and Yetman (2013) report that sophisticated donors discount the inflated ratios more and discount ratios that are inflated by more complex methods. Tinkelman (1998) study the impact of joint costs

allocation on donations. He finds that larger donors, who are likely to examine the financial statements in detail, respond more negatively to inefficient joint costs allocations. Although most of these studies do not investigate the earnings figure, they guide this research in separately studying the impact of sophistication on nonprofit management's manipulative behaviour.

There is scant literature on the relationship between sophistication and earnings management. Based on the discussed ratio manipulation literature (e.g. Tinkelman 1998; Yetman and Yetman, 2013; Balsam and Harris, 2014; Parsons et al., 2017) and a limited accruals-based earnings management literature (e.g. Greenwood and Tao, 2016), I expect the sophistication of funders to be a deterrent against accrual-based earnings manipulation and therefore formulate the following hypothesis:

H3: The relationship between discretionary accruals and earnings before discretionary accruals is less negative for charities with more sophisticated funders than for charities with less sophisticated funders.

In addition to the sophistication of the charity funders, the restrictions placed by the funders may also be a factor in financial reporting of the charities. A charity that receives a lump-sum donation where the donor stipulates that the money is invested to provide a regular stream of income is categorised as an endowed charity. The income itself is not necessarily restricted, but the essence for such restriction is to preserve the endowment fund; therefore, it is customary for only the income from investment to be spent for charitable causes while the endowment fund is kept intact. The UK regulations allow charities to spend permanent endowments in certain circumstances by special permission from the Charity Commission. In some cases, nonprofits may be more restricted in spending these endowments. For example, if charities are funded mainly via government grants, have relatively stronger control policies and therefore a higher level of scrutiny, then they are more restricted (e.g. Rose-Ackerman, 1981; Ostrower, 2007). A 'Permanent endowment' is meant to be held by a charity forever. It is usually set out as a restriction in the charity's governing document. The purpose for this is to invest and earn additional income, and preserve the endowed wealth in perpetuity.

Since the endowment fund is set out as a restriction, just as other restricted funds that are donated by sophisticated funders, I hypothesise that the likelihood of manipulation

would be less prevalent for an endowment charity due to the sophistication of its funders.

H4: The relationship between discretionary accruals and earnings before discretionary accruals is less negative for endowment charities than for non-endowment charities.

Although all nonprofits cannot be fit neatly into one category, those nonprofits that receive most or all of their income from grants/donations, are categorised as "donative" and those that rely predominantly on income from the sale of services are classified as "commercial" (Hansmann, 1980). These two types have also been referred to as charitable nonprofits and service-oriented nonprofits, respectively (e.g. Yetman and Yetman, 2013; Balsam and Harris, 2014), where, the charitable nonprofits receive donations mostly from donors who are not themselves the recipients of its services, as opposed to service-oriented charities, where donors are also in receipt of such charities' services (e.g. museums who charge entrance fees including a donation). This donor-beneficiary separation is expected to have an impact on the earnings management behaviour of the managers.

Differences between these types of charities have been found in terms of donation levels in response to executive compensation and accounting quality. Specifically, Balsam and Harris (2014) find a stronger negative relationship between executive compensation and future donations for more charitable nonprofits, and a weaker relationship for more service-oriented charities. Yetman and Yetman (2013) in a sample of 78,959 nonprofit firm-year observations from 1992 to 2007 find that smaller donors do not react to more complex measures of accounting quality. Therefore, it may be that more service-oriented nonprofits would have more compelling incentives to manage earnings using the accruals-based method in response to funder pressures. On the other hand, their more charitable counterparts may also face pressures due to the agency of the media that scrutinises charities on donors' behalf. Therefore, it is difficult to form an a priori assumption about which of the two types may be more prone to exercising AEM. I, therefore, form a non-directional prediction for the effect of more service-oriented charities on the relationship between accounting-based discretion and earnings before discretionary accruals relationship.

H5: The relationship between discretionary accruals and earnings before discretionary accruals is different for service-oriented charities compared with their more charitable counterparts.

Following Leone and Van Horne (2005), in addition to investigating AEM, in the same study I also explore the existence of REM in UK nonprofits. It is an important part of the study as making real changes to spending is potentially more dysfunctional than manipulating accounting information (Parsons et al., 2017). Eldenburg et al. (2011) make an important contribution in determining real earnings management in nonprofits but with a small sample size. They find that hospitals with stronger incentives to manage earnings upwards (downwards) experience significantly larger decreases (increases) in non-revenue-generating and non-operating activities expenditures. According to Hoerger (1991), nonprofits minimise the variance in profits by cutting back or increasing real spending of their choice variable in their objective function. I would expect that charities curtail their fundraising spending, which to an extent would be discretionary, in the years when expected earnings are below zero and increase their fundraising spending when the expected earnings are above a small surplus range. Therefore, I formulate the following hypothesis when earnings are below and above the zero-profit benchmark.

H6: When nonprofits' earnings are expected to be below (above) the benchmark, nonprofits will decrease (increase) spending on fundraising activities.

Just like the presence of large stockholders is associated with accurate reporting in the for-profit setting, donors act as stockholders in nonprofits. The donors provide funding and large donations tend to place restrictions on the use of their donations (Yates and Yates, 2012). Guo et al. (2015) indicate that sophisticated investors improve the accounting oversight curbing earnings manipulation via operating activities regulations. Restricting donations give donors direct control over where, when, and how the organisation spends its resources (Loftin, 1998). With the fear that debt holders, being another sophisticated stakeholder group would be suspicious, municipalities' managers do not manipulate earnings upward in the public sector (Beck, 2018).

The formal compliance with financial reporting standards improves with dependence on funding sources such as government subsidies and financial debts (Verbruggen et

al., 2011). As the economic impact of real earnings management is expected to be higher than accruals-based earnings management, sophisticated funders must be particularly interested in maintaining the level of “real” services to the end beneficiaries and that they do not freely fluctuate in pursuit of a target bottom line. Therefore, I formulate the following hypothesis:

H7: When nonprofits’ earnings are expected to be above (below) the benchmark, nonprofits with more sophisticated funders are less likely to increase (decrease) spending on fundraising activities than nonprofits with less sophisticated funders.

Similarly, I would expect, the charities that are predominantly funded through endowments would face higher scrutiny from relatively sophisticated funders. Also, they would have weaker incentives to make real spending manipulation, as their income is relatively assured from mostly connected and closely associated donors. Therefore, I formulate the following hypothesis:

H8: When nonprofits’ earnings are expected to be above (below) the benchmark, nonprofits with high endowment funding are less likely to increase (decrease) spending on fundraising activities than other nonprofits.

According to the for-profit literature, managers might find it difficult to manipulate real activities when their operation is being monitored closely (e.g. Bushee, 1998; Roychowdhury, 2006; Zang, 2012). The fact that the donor-beneficiary separation is minimal in more service-oriented charities would suggest closer monitoring of the “real” services by the beneficiaries, who are their funders, either institutional or small donors. The “*supporters who are recipients of nonprofit services can directly evaluate the quality of those services*” (Balsam and Harris, 2014). The level of real earnings management activities increased significantly after the passage of Sarbanes-Oxley (SOX) due to increased scrutiny (Cohen et al. 2008). Similarly, a surge in real manipulation was noticed after the adoption of International Financial Reporting Standards (Ferentinou and Anagnostopoulou, 2016), at the time of seasonal equity offerings (Kothari et al., 2015) and with better audit quality (e.g., Chi et al., 2011). Therefore, this suggests that a stricter inspection, either through the enactment of a tighter reporting regime or tighter scrutiny is associated with more real manipulation. In the same vein, I expect that a service-oriented charity would be less manipulative

using real discretionary spending as their donors, who are also the recipients of their services, would have other ways than financial statements to gauge the performance of a charity; hence making the accounting-based manipulation more likely than a charitable nonprofit. A charitable nonprofit, with donor-beneficiary separation, would face heightened financial statement scrutiny due to the limited first-hand experience of the charity's services. This would suggest a higher real activities management than accounting-based manipulation, which is not easily detectable through financial statement scrutiny; something that charitable nonprofit donors are expected to rely on more. Therefore, I formulate the final hypothesis below:

H9: When nonprofits' earnings are expected to be above (below) the benchmark, nonprofits that are service-oriented are less likely to increase (decrease) spending on fundraising activities compared to charitable nonprofits.

3.3 Data and sample

3.3.1 Sample

The data used for this study is from the Charity Commission for England and Wales dataset.⁵⁵ The charities are required to submit their accounts to the Charity Commission within ten months of their financial year-end. Due to limited data availability, the sample consists of all firms with gross income over £0.5m from 2007 to 2016. Until 2015, the audit threshold for registered charities was £1m, which was subsequently reduced to £0.5m under the Charity Statement of Recommended Practice (SORP: FRS102).⁵⁶ Hence, the data do not exclude any charity which would have required a statutory audit in the period of study. I exclude firms that earned trading income because discretionary accruals would carry a measurement error due to the unavailability of data on inventory in the annual returns filed by charities to the Charity Commission.⁵⁷ All charities with three years of data were included in the sample. In all regressions, standard errors are clustered by firm (Petersen 2009).

⁵⁵ The content is available under the Open Government Licence v3.0.

⁵⁶ In England and Wales, an audit is required if either the charity's gross income exceeds £500,000 or its gross assets exceed £3.26m and gross income exceeds £250,000.
http://www.charitysorp.org/media/619101/frs102_complete.pdf

⁵⁷ All auditable charities are required to complete Part b of the online annual return.

3.3.2 Classification of nonprofits

An organisation's operating strategy depends on the expectations of its resource providers (Drees & Heugens, 2013; Pfeffer & Salancik, 1978). The degree to which an organisation depends on a particular source of income is the first major determinant of resource importance according to RDT. The resource importance is dependent on the relative magnitude of that resource to the total income of a charity. "*Resource size is measured on its relative magnitude to total revenues*" (Parsons et al., 2017, p707). I classify my sample in light of the relative resource dependency and test my hypotheses accordingly.

The first classification relates to the type of funders in terms of sophistication. Prior literature (e.g. Yetman and Yetman, 2013; Balsam and Harris, 2014; Amin and Harris, 2017) classifies sophistication according to the level of restricted funds or donations, suggesting that sophisticated donors are more likely to place permanent or temporary restrictions on their donations.⁵⁸ I use the level of restricted funds (following Yetman and Yetman, 2013) as the criterion for categorising a charity as sophisticated or Less sophisticated. Those charities which have above-median restricted funds within their respective nonprofit subgroup classification are categorised as sophisticated. Hence to measure donor sophistication I partition organisations in each charity subgroup by the presence of restricted donations using a 0/1 dummy variable, where 1(0) represents a charity with more sophisticated (less sophisticated) donors.

The second classification of nonprofits is according to their source of funding from endowment. This has not been previously used as a classification in prior literature. First, I calculate the endowment fund ratio by dividing the year-end endowment fund by the year-end total funds. Those charities that have an above-median level of endowment fund ratio within their respective charity subgroup, have been categorised as endowed charities. Hence, an endowed charity has a relatively sizeable income from its endowment fund.

Finally, to test the impact of more service-oriented charities against more charitable nonprofits, following Balsam and Harris (2014), I partition the sample according to the median of programme service revenue (hereafter, PSR), which is measured as the ratio of programme service revenue to total revenue. The firms with higher PSR than

⁵⁸ Relatively older studies use accounting expertise or donor size as proxies for sophistication (e.g. Keating et al., 2008; Tinkelman, 1998)

the median of their respective nonprofit subcategory classification are categorised as more service-oriented and those below the median as charitable. Hence to measure donor-beneficiary proximity I partition organisations in each charity subgroup by PSR using a 0/1 dummy variable, where 1(0) represents a more service-oriented (charitable) nonprofit.

To classify nonprofits by industry or subcategory, I use the Charity Commission data, merged with the classification specified by the International Classification of Nonprofit Organisations (ICNPO)⁵⁹ (Salamon and Anheier, 1996). All charities have been classified using the International Classification of Nonprofit Organisations (ICNPO) as listed in appendix 3.2. Except for group 12 (Not elsewhere classified), all classifications have been allocated according to the median values of each respective group. The charities in group 12 have been dropped from the analysis, as the median value for a miscellaneous group may not be a good representation of the individual nonprofits placed in that group. Following the extant literature (e.g. Yetman and Yetman, 2013; Balsam and Harris, 2014) the classification for the main analysis is based on median levels of PSR and restricted funds. The grouping of endowment charities is made in a similar vein.

This categorisation is superior to the earlier studies, where the median value of the entire sample is taken as reference points. In this study, I am more careful by using the median-level criterion for the classification at each subgroup level.

Robustness tests are carried out using the ratios as continuous variables; they give similar results.

3.4 Manipulation measures

I use two measures of manipulation to investigate earnings management: accrual and real manipulation. The measure of accrual manipulation is discretionary accruals (DACC). The early studies by Healy (1985), DeAngelo (1986) and Jones (1991) suggested models of discretionary or abnormal accrual models to detect earnings management. Dechow et al. (1995) report that among the aforementioned models, a modified version of the Jones (1991) model is the most powerful method of detecting

⁵⁹ The National Council of Voluntary Organisations classification data was merged with Charity Commission data to allocate charity types according to the International classification.

earnings manipulation. A vast amount of extant literature employs the Jones (1991) model as a basis for estimating discretionary accruals. The discretionary accruals are used to indicate the quality of earnings recognising that accruals are likely to be the result of managerial discretion and changes in the firm's economic environment (Hermanns, 2006).

In this study, in accordance with previous literature in the charity sector accruals-based earnings management (e.g. Bouwens et al, 2004; Leone and Van Horn, 2005; Ballantine et al., 2007; Verbruggen and Christiaens, 2012), I use an aggregate accruals model primarily based on the Jones (1991) model with modifications proposed by Dechow et al. (1995) and Kothari et al. (2005).⁶⁰

I use a cross-sectional model of discretionary accruals, which is used in various studies such as in Ibrahim and Lloyd (2011), where for each year, I estimate the model for every charity subgroup (industry) according to the Charity Commission classification. In doing so, I partially control for any changes that are specific to each charity subgroup. The modified Jones model is estimated for all charity classifications as follows:

$$\frac{ACC_{it}}{TA_{it-1}} = \alpha_0 + \beta_1 \frac{TA_{it-1}}{TA_{it-1}} + \beta_2 \frac{\Delta REV_{it}}{TA_{it-1}} + \beta_3 \frac{PPE_{it}}{TA_{it-1}} + \beta_4 \frac{ROA_{it}}{TA_{it-1}} + \varepsilon_{it} \quad (3.1)$$

Where:

ACC_{it} is total reported accruals; It is calculated as the change in current assets (excluding cash) from year t-1 to year t, less the change in current liabilities from year t-1 to year t, minus depreciation charge for the year;

TA_{it-1} is total assets in year t-1;

ΔREV_{it} represents annual change in revenues from year t-1 to year t;

PPE_{it} denotes property, plant, and equipment for firm i in year t;

⁶⁰ Kothari et al. (2005) developed the modified Jones model by adding Return on Asset (ROA) as an additional independent variable to the modified Jones model to control for performance in the discretionary accrual regression. ROA is a better measure than many other variables such as size, market-to-book, earnings yield, etc. and complements other studies that document ROA as a better measure of performance (e.g. Dechow 1994; Barber & Lyon, 1996 and Cheng et al., 2008). Extensive previous research recommends and attempts to develop accrual models as a function of performance (e.g. Barth et al. 2001, Peasnell et al., 2000, Dechow et al., 1998; Guay, et al., 1996; Healy, 1996). According to them the forecasted accruals of firms that have unusual performance might be systematically non-zero, pointing to a potential correlation between firm performance and accruals.

ROA_{it} is the return on assets measured as net income for firm i in year t divided by total assets in year t ; and

ε_{it} is the error term.

I run industry-specific regression models and use their residuals to proxy for discretionary accruals ($DACC$). It is worth noting that the accruals calculation in the extant literature comprises inventory. The Charity Commission data does not include separate figures for inventory. Although the amount of inventory in the charity sector is expected to be negligible compared to the for-profit sector, to alleviate the risk of measurement error, I remove all those firm years where there were any expenses on trading expecting that the trading charities would have inventory within their current assets.⁶¹

The second measure of manipulation relates to real accounts. Real earnings management involves manipulation of operating, investing, or financing activities. There are several ways to manipulate earnings using real accounts such as the overproduction of finished goods inventory to suppress cost of goods sold (COGS), hence higher gross profit, or disposal of fixed assets to inflate profit (e.g. Bartov, 1993; Herrmann et al. 2003; Roychowdhury, 2006; Xu et al., 2007; Gunny, 2010), relaxing credit terms by offering price discounts to accelerate sales (e.g. Cohen et al., 2008; Kothari et al., 2015), curtailing the discretionary expenses e.g. research and development (R&D) and selling, general and administrative (SG&A) expenses (e.g. Roychowdhury, 2006; Gunny, 2010; Zang, 2012).

Real activities management in nonprofits relates to the decisions that can be implemented swiftly, hence affecting accounting performance quickly. I expect that real earnings management for nonprofits can either be achieved by regulating fundraising activities or fundraising expenses. Fixed costs are allocated between charitable and fundraising costs and therefore it would not be easy to decouple fixed from variable costs, which I would expect to be more discretionary.

Advertisement expense is characteristically acknowledged as a discretionary expense in the literature (e.g. Gunny, 2005; Cohen et al., 2010; Cohen and Zarowin, 2010;

⁶¹ The effect of such inventory is very small and the results are very similar even when the firm years with more than zero pounds of trading expenses are included in the final sample.

Eldenburg et al., 2011;). In nonprofits, the fundraising expenses are incurred to induce contributions. These fundraising costs are associated with fundraising campaigns, mailings for funds from supporters, and other solicitations for contributions from individuals, foundations, and governments; in other words, they effectively advertise the nonprofit to raise awareness. A large portion of fundraising cost typically relates to the advertising employing various sources such as a grand fundraising gala dinner. Even though the solicited funds and contributions may not come in until a later date (maybe even in the subsequent year), the cost of mailing solicitation letters and the salaries of development/fundraising employees should be expensed as the expense is incurred. Advertising expenditures could be cut back or postponed (Eldenburg et al., 2011), therefore fundraising expenses could be an ideal candidate for managing earnings through discretionary expenses. Due to the absence of investors or analysts, a specific benchmark of earnings is not relevant; it is, however, clear from literature that there is a discontinuity around zero (e.g. Burgstahler and Dichev, 1997; Degeorge et al. 1999; Leone and Van Horn, 2005; Eldenburg et al., 2011), possibly due to earnings management. Firms also avoid small losses (e.g. Leone and Van Horn, 2005; Gunny, 2010) and prefer a small surplus. To study REM in charities, I use prior literature to use small earnings as a target benchmark that managers pursue. I focus on fundraising activities as the discretionary expense to be manipulated.

3.5 Descriptive statistics

Table 3.1 reports the descriptive statistics for all charity years in the sample. The mean (median) total income deflated by lagged total assets is 1.46 (0.86). A large number of very small and a small number of very large charities drive the skewness. The mean (median) of fundraising expenses (FR) deflated by lagged total assets is 0.08 (0.00), showing that most charities have a very low level of fundraising costs in their SoFA. The mean (median) of Net_Income deflated by lagged total assets is 0.06 (0.02), showing that most charities' results lean towards a small surplus. After winsorising the variables at the 1% and 99% percentiles of the distribution, the positive mean net income is consistent with charities aiming for small surpluses.

Table 3.1: Descriptive Statistics

Variable	Obs.	Mean	Median	Std. Dev.	25%	75%
$Income_t$	103,469	1.46	0.86	1.94	0.38	1.79
$\Delta Income_t$	88,739	0.04	0.01	0.39	-0.04	0.11
Net_Income_t	88,743	0.06	0.02	0.22	-0.02	0.08
$Log(Assets_t)$	103,469	14.81	14.66	1.71	13.52	15.98
$FR\ Expenses_t$	103,469	0.08	0.00	0.22	0.00	0.04
$\Delta FR\ Expenses_t$	88,739	-0.01	0.00	0.10	0.00	0.00
ACC_t	88,743	-0.03	-0.02	0.2	-0.07	0.02
ΔREV_t	88,743	0.07	0.01	0.48	-0.05	0.12
PPE_t	88,743	0.54	0.62	0.40	0.10	0.88
ROA_t	103,469	0.04	0.02	0.20	-0.02	0.09
$DACC_t$	88,731	0.00	0.01	0.19	-0.05	0.05
$EBDA_t$	88,731	0.06	0.01	0.29	-0.06	0.12

Table 3.2: Correlation**Panel A: Spearman (Below)/Pearson (Above) Correlation Matrix (AEM)**

Variable	Net_Income_t	ACC_t	ΔREV_t	PPE_t	ROA_t	$DACC_t$	$EBDA_t$
Net_Income_t	1	0.191	0.404	-0.004	0.899	0.026	0.788
ACC_t	0.151	1	-0.183	-0.033	0.221	0.921	-0.390
ΔREV_t	0.331	-0.174	1	-0.045	0.321	0.000	0.336
PPE_t	-0.023	-0.035	-0.033	1	0.062	0.000	-0.004
ROA_t	0.997	0.160	0.329	-0.027	1	0.000	0.727
$DACC_t$	-0.103	0.832	-0.069	0.049	-0.098	1	-0.568
$EBDA_t$	0.699	-0.400	0.288	-0.045	0.693	-0.662	1

Panel B: Spearman (Below)/Pearson (Above) Correlation Matrix (REM)

Variable	$Income_t$	$\Delta Income_t$	$Log(Assets_t)$	$FR Expenses_t$	$\Delta FR Expenses_t$
$Income_t$	1	0.150	-0.589	0.298	-0.033
$\Delta Income_t$	0.236	1	-0.040	0.042	0.119
$Log(Assets_t)$	-0.750	-0.088	1	-0.216	0.043
$FR Expenses_t$	0.129	0.040	-0.048	1	0.260
$\Delta FR Expenses_t$	0.007	0.104	0.022	0.310	1

Variable definitions:

Variable	Definition
$Income_t$	Income in year t (similar to revenues in for-profit organisations), deflated by lagged total assets.
$\Delta Income_t$	Change in Income from year t-1 to t, deflated by lagged total assets.
Net_Income_t	Net income in year t, deflated by lagged total assets.
$Log(Assets_t)$	Natural logarithm of total assets in year t.
FR_t	Fundraising expenses in year t, deflated by lagged total assets.
ΔFR_t	Change in fundraising expenses from t-1 to t, deflated by lagged total assets.
ACC_t	Accruals in year t, deflated by lagged total assets.
ΔREV_t	Change in revenues from year t-1 to year t, deflated by lagged total assets.
PPE_t	Property, plant, and equipment in year t, deflated by lagged total assets.
ROA_t	Return (Net Income) on assets in year t measured as net income in year t divided by total assets in year t.
$DACC_t$	Discretionary accruals in year t from equation (1) of chapter 3.
$EBDA_t$	Earnings before discretionary accruals in year t, measured as net income in year t less discretionary accruals.

3.6 Hypotheses testing**3.6.1 Accrual manipulation**

To test the first hypothesis, I use Burgstahler and Dichev's (1997) methodology which is based on the analysis of the frequency distribution of earnings, with the assumption that, in the presence of earnings management, this distribution will be not be smooth around the benchmark (in this case zero-profit). Burgstahler and Dichev (1997) use net earnings deflated by lagged market value as their variable of choice. As charities

do not have equity, I use lagged total assets as the deflator following the earlier nonprofit literature (e.g. Leone and Horn, 2005; Ferreira et al., 2013). I also present the distribution of earnings before discretionary accruals, which should be smooth around the benchmark.

Figure 3.1 in the Appendix (panels A and B) present the histograms of earnings before discretionary accruals (EBDA) and net income respectively. Both EBDA and net income are deflated by lagged total assets using bin widths of 0.005.⁶² Similar to earlier studies (e.g. Burgstahler and Dichev, 1997; Leone and Van Horn, 2005; Jacob and Jorgensen, 2007; Gore et al., 2007; Bennett et al., 2017), the distribution of EBDA (Figure 3.1 – Panel A) is compared with that of net income (Panel B). The histograms show that a large number of charities' earnings have been shifted to slightly right of zero. The mean (standard deviation) of EBDA and net income are not significantly different at 0.056 (0.286) and 0.056 (0.222) respectively. This confirms Leone and Van Horn's (2005) assertion, that overall, discretionary accruals do not contribute in altering the mean and medians but they do reduce the variance. The standard deviation is reduced from 0.286 for EBDA to 0.222 for net income. A one-tailed F-test for differences in variances is significant and strongly rejects the null of the two distributions as equal at $p < 0.001$.

To further study whether the distribution of net income is smooth, I conduct statistical tests similar to those performed by Leone and Van Horn (2005) (following Burgstahler and Dichev, 1997). For the test, the null hypothesis is for a smooth distribution of net income. The literature suggests that the smoothness is confirmed if the number of observations in a given interval (i) is equal to the expected number of observations in that particular interval.⁶³ I find that the z-score of the standardised difference to the left

⁶² Following Degeorge et al. (1999) the bin widths were chosen using the formula $2(IQR)n^{-1/3}$. n denotes the number of available observations where IQR represents the interquartile range.

⁶³ Expected number is the average of the adjacent intervals on either side i.e. $i-1$ and $i+1$. If the actual is more in the subject interval (i) then the difference can be statistically tested by calculating the difference between the expected and actual number in the relevant bin and divide by the estimated standard deviation. The estimated standard deviation of an interval can be calculated using a probability distribution. The standardised differences are calculated by dividing the difference between actual and observed observations in the interval (i) with the expected standard deviation of that interval. The variance (being the square of standard deviation) of the difference between actual and expected observations is approximately as follows:

$$Np_i(1-p_i) + (1/4)N(p_{i-1} + p_{i+1})(1-p_{i-1} - p_{i+1})$$

where N is the number of observations and p_i is the probability for observation to fall into the interval i . Under the null, I would expect a normal distribution with a mean of 0 and the standard deviation of 1. My results are even more compelling than Leone and Van Horn's (2005) as I observe negative signs in the adjacent bins to the happy range pointing to the fact that the expected numbers are lower on either side of the target range of small surplus and adding to the conviction that firms have chosen to move out of those intervals into the small surplus interval.

of the benchmark range in Panel B is -0.58, which is not significantly different from 0. On the other hand, the z-score of the standardised difference in the interval to the immediate right of the benchmark range is -0.68, which is not significantly different from zero and is in the predicted direction. The benchmark range has a disproportionately high number of firm years with a z-score of the standardised difference of 2.35 which is significantly different from 0. Therefore, there is a higher than expected number of charities that report zero profits. This provides limited support to the first hypothesis.

The correlation matrix in table 3.2 shows low correlation between the independent variables used in the estimation regression, following earlier literature (e.g. Jones, 1991; Leone and Van Horne, 2005; Verbruggen and Christiaens, 2012) with a correlation coefficient between ΔREV_{it} and PPE_{it} of -0.033, and 0.33 between ΔREV_{it} and ROA_{it} . Similarly the coefficient between ROA_{it} and PPE_{it} is also sufficiently low at -0.027.

The mean and median results of the estimation regression are presented in Table 3.3. I run regressions for each industry year and the respective normal level of accruals are applied for each industry and year to estimate abnormal accruals, a proxy for earnings management. The mean (median) R^2 for the equations is 0.15 (0.14). The average estimated coefficient for property, plant, and equipment is positive (0.378). Although earlier studies in nonprofit earnings management studies do not report the results of the estimation regression, I would expect a positive expected sign for property, plant, and equipment because of the income-increasing accrual due to the large legacy income in the form of assets. However, a negative sign is also plausible due to depreciation charge as for Jones (1991). (Leone and Van Horne, 2005). The expected sign for the change in revenues coefficient is not as obvious as in the case of Jones (1991). The change in income can cause income-increasing changes in some working capital accounts (e.g., increases in accounts receivable) and income-decreasing changes in others (e.g., increases in accounts payable). It is probable that the positive sign represents that most income of charities is not accrued due to the unpredictability and prudence but their expenses may be.

This is confirmed by the positive sign of the difference in the happy range, suggesting that the firms have migrated into that range more than the expected number of firms in this range.

Table 3.3: Estimation models results

Estimation models for normal levels of accruals

The table presents results of the regression of the forms:

$$ACC_{it}/TA_{it-1} = \alpha_0 + \beta_1/TA_{it-1} + \beta_2\Delta REV_{it}/TA_{it-1} + \beta_3PPE_{it}/TA_{it-1} + \beta_4ROA_{it}/TA_{it-1} + \varepsilon_{it} \quad (3.1)$$

Independent Variable	Dependant Variable: ACC_t/TA_{t-1}			
	Mean		Median	
	Coeff	P-value	Coeff	P-value
<i>Intercept</i>	0.001	0.179	0.002	0.136
$1/TA_{t-1}$	-5152.79	0.136	-4376.09*	0.076
$\Delta REV_t/TA_{t-1}$	-0.133***	0.004	-0.122***	0.000
PPE_t/TA_{t-1}	0.378***	0.001	0.373***	0.000
ROA_t/TA_{t-1}	-0.043*	0.097	-0.048**	0.023
R^2	0.15		0.14	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Variable definitions:

Variable	Definition
ΔREV_t	Change in revenues from year t-1 to year t, deflated by lagged total assets.
PPE_t	Property, plant, and equipment in year t, deflated by lagged total assets.
ROA_t	Return (Net Income) on assets in year t measured as net income in year t divided by total assets in year t.
TA_{t-1}	Total assets in year t-1

For EBDA, I find that the z-score of the standardised differences for the benchmark range and the two adjacent ranges on either side are all not significantly different from zero. The interval on the left of the benchmark range in Panel A has the z-score of the standardised difference of -0.17, which is not significantly different from 0. Similarly, the z-score of the standardised difference in the interval to the immediate right of the benchmark range is -0.44, which is also not significantly different from zero and in the predicted direction. The benchmark range of the interval between 0 and -0.005 has a z-score of the standardised difference of 0.29. That is also not significantly different from 0. This supports Leone and Van Horn's (2005) inference that managers use discretionary accruals to manage earnings to report a small surplus and avoid

losses. The difference in Panels A and B of Figure 3.1 rejects the possibility that the kink could be entirely due to operating activities. Therefore, I find limited support for hypothesis 1, that charities are more likely to report a small surplus compared to a small deficit.

To test the second hypothesis, I follow the methodology set by Leone and Van Horn (2005). I begin with the following model to examine the relationship between earnings before discretionary accruals (EBDA) and discretionary accruals:

$$DACC_{it} = \alpha_0 + \beta_1 EBDA_{it} + \beta_2 Net_Income_{it-1} + \beta_3 DACC_{it-1} + \varepsilon_{it} \quad (3.2)$$

Where:

$DACC_{it}$ is discretionary accruals in year t from equation (3.1);

$EBDA_{it}$ is earnings before discretionary accruals in year t, measured as income in year t less discretionary accruals;

Net_Income_{it-1} is net income in year t-1 deflated by lagged total assets; and

ε_{it} is the error term.

Following the literature (e.g. Leone and Van Horn, 2005), assuming that discretionary accruals are used to report a small surplus, I expect an inverse relationship between $DACC_{it}$ and $EBDA_{it}$. Net_Income_{it-1} is added as a control variable because there is a positive relationship between past performance and discretionary accruals for the present period. A positive sign is expected for β_2 . $DACC_{it-1}$ controls for the probability of autocorrelation in discretionary accruals (e.g. Leone and Van Horn, 2005; Ferreira et al., 2013).⁶⁴ I also include a control for size ($Log(Assets_{t-1})$) and change in income. Although the sign remains positive when the regression is run as a simple OLS (e.g. Leone and Van Horn, 2005; Ferreira et al., 2013), when year fixed effects are included and standard errors are clustered by nonprofit subgroups in the model, the sign becomes negative. The results are presented in table 3.4 without the addition of the two control variables: size and change in income.

⁶⁴ Following Petersen (2009) methodology, I run linear regression with standard errors clustered by firms. This is done so the standard errors are unbiased and produce a more accurate size of confidence intervals considering temporary or permanent firm effects.

Table 3.4: Tests of accrual manipulation in charities

The table presents results of the regression of the form:

$$DACC_{it} = \alpha_0 + \beta_1 EBDA_{it} + \beta_2 Net_Income_{it-1} + \beta_3 DACC_{it-1} + \varepsilon_{it} \quad (3.2)$$

Independent Variable	Prediction	Coeff	P-value
<i>Intercept</i>		0.021***	0.000
<i>EBDA_t</i>	-	-0.391***	0.000
<i>Net_Income_{t-1}</i>	+	-0.062***	0.000
<i>DACC_{t-1}</i>		-0.181***	0.000
<i>Observations</i>		74,319	
<i>R²</i>		0.35	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Variable definitions:

Variable	Definition
<i>Net_Income_t</i>	Net income in year t, deflated by lagged total assets.
<i>DACC_t</i>	Discretionary accruals in year t from equation (1) of chapter 3.
<i>EBDA_t</i>	Earnings before discretionary accruals in year t, measured as net income in year t less discretionary accruals.

The results in table 3.4 indicate that there is a negative and significant coefficient between discretionary accruals and EBDA ($\beta_1 = -0.391$, significant at the 1% level). Therefore, hypothesis 2 is supported, whereby there is evidence that charities use more discretionary accruals when earnings before discretionary accruals are lower. In terms of the control variables, the results indicate that larger firms with higher past performance have lower current year discretionary accruals.

I run equation 2 regression, when EBDA is a) above zero b) below zero. The results as tabulated in Table 3.5 confirm that the relationship between discretionary accruals and earnings before discretionary accruals is more negative for the firms with pre-managed earnings below zero. This supports the hypothesis that a deficit is less desirable for charities than a small surplus with a significantly negative relationship of EBDA with DACC (coefficient -0.31 for the firms with positive EBDA and -0.59 for the nonprofits with negative EBDA).

Table 3.5: Tests of accrual manipulation in charities by direction of manipulation

The table presents results of regressions across positive and negative EBDA of the form:

$$DACC_{it} = \alpha_0 + \beta_1 EBDA_{it} + \beta_2 Net_Income_{it-1} + \beta_3 DACC_{it-1} + \varepsilon_{it} \quad (3.2)$$

		Charities with positive EBDA		Charities with negative EBDA	
Independent Variable	Prediction	Coeff	P-Value	Coeff	P-Value
<i>Intercept</i>		0.002	0.248	0.003**	0.020
<i>EBDA_t</i>	-	-0.311***	0.000	-0.594***	0.000
<i>Net_Income_{t-1}</i>	+	-0.085***	0.000	-0.021**	0.012
<i>DACC_{t-1}</i>	?	-0.181***	0.000	-0.118***	0.000
<i>Observations</i>		40,985		35,391	
<i>R²</i>		0.18		0.37	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Variable definitions:

Variable	Definition
<i>Net_Income_{t-1}</i>	Net income in year t-1, deflated by lagged total assets.
<i>DACC_t</i>	Discretionary accruals in year t from equation (1) of chapter 3.
<i>EBDA_t</i>	Earnings before discretionary accruals in year t, measured as net income in year t less discretionary accruals.

Hypotheses 3, 4 and 5 relate to the behaviour of charities that have different types of funders i.e. sophisticated vs. unsophisticated, endowment vs. no-endowment, and service-oriented vs. charitable. I use the following regressions to test these hypotheses:

$$DACC_{it} = \alpha_0 + \beta_1 EBDA_{it} + \beta_2 Sophisticated_{it} + \beta_3 EBDA_{it} * Sophisticated_{it} + \beta_4 Net_Income_{it-1} + \beta_5 DACC_{it-1} + \varepsilon_{it} \quad (3.3)$$

$$DACC_{it} = \alpha_0 + \beta_1 EBDA_{it} + \beta_2 Endowment_{it} + \beta_3 EBDA_{it} * Endowment_{it} + \beta_4 Net_Income_{it-1} + \beta_5 DACC_{it-1} + \varepsilon_{it} \quad (3.4)$$

$$DACC_{it} = \alpha_0 + \beta_1 EBDA_{it} + \beta_2 Service_{it} + \beta_3 EBDA_{it} * Service_{it} + \beta_4 Net_Income_{it-1} + \beta_5 DACC_{it-1} + \varepsilon_{it} \quad (3.5)$$

Where *Sophisticated* is a dummy variable equal to 1 if the charity has above-median restricted funds within its respective nonprofit classification, and 0 otherwise;

Endowment is a dummy variable equal to 1 if the charity has above-median endowment fund ratio (end of year endowment fund divided by total funds) within its respective nonprofit classification, and 0 otherwise;

Service is a dummy variable equal to 1 if the charity has above-median programme service revenue to total revenue within its respective nonprofit classification, and 0 otherwise;

All other variables are as previously defined.

The results of the equations are tabulated in Table 3.6. The coefficient on the interaction of charity with more sophisticated donors with EBDA is significantly positive at the 5% significance level (coefficient 0.026; $p=0.045$), suggesting that a charity with more sophisticated donors is less likely to manipulate earnings using discretionary accruals. Similarly, nonprofits that receive their largest funds from the endowments are less likely to manipulate the earnings figure (coefficient 0.066; $p=0.003$). This can be explained by a regularly assured stream of income from an endowment, pointing to a lower persistent resource dependency from the endowing funders of an endowed nonprofit. My finding extends this to accruals-based earnings management. In order to disentangle the complexities of accruals-based earnings management, small and unsophisticated donors would require data across charities and time. To analyse “normal” levels of accruals and any deviations, they would need to utilise statistical models which are far more formal than “heuristics” (Yetman and Yetman, 2013) for an unsophisticated funder. Tinkelman (1998) use the size of donors as a proxy for their sophistication. They find that larger donors are more likely to discount joint cost disclosures relative to smaller (less sophisticated) donors, whereas Khumawala et al. (2005) find that expert donors are less likely to discount joint cost disclosures relative to novice donors.

Table 3.6: Tests of accrual manipulation in charities related to type of funders

The table presents results of regressions of the form:

$$DACC_{it} = \alpha_0 + \beta_1 EBDA_{it} + \beta_2 Sophisticated_{it} + \beta_3 EBDA_{it} * Sophisticated_{it} + \beta_4 Net_Income_{it-1} + \beta_5 DACC_{it-1} + \varepsilon_{it} \quad (3.3)$$

$$DACC_{it} = \alpha_0 + \beta_1 EBDA_{it} + \beta_2 Endowment_{it} + \beta_3 EBDA_{it} * Endowment_{it} + \beta_4 Net_Income_{it-1} + \beta_5 DACC_{it-1} + \varepsilon_{it} \quad (3.4)$$

$$DACC_{it} = \alpha_0 + \beta_1 EBDA_{it} + \beta_2 Service_{it} + \beta_3 EBDA_{it} * Service_{it} + \beta_4 Net_Income_{it-1} + \beta_5 DACC_{it-1} + \varepsilon_{it} \quad (3.5)$$

		<i>Sophisticated</i>		<i>Endowment</i>		<i>Service</i>	
Independent Variable	Prediction	Coeff	P-Value	Coeff	P-Value	Coeff	P-Value
<i>Intercept</i>		0.013***	0.000	0.021***	0.000	0.028***	0.000
<i>EBDA_t</i>	-	-0.407***	0.000	-0.396***	0.000	-0.337***	0.000
<i>Sophisticated_t</i>	?	0.015***	0.000				
<i>Endowment_t</i>	?			-0.002	0.691		
<i>Service_t</i>	?					-0.011***	0.000
<i>EBDA_t</i>							
<i>* Sophisticated_t</i>	+	0.026**	0.045				
<i>EBDA_t * Endowment_t</i>	+			0.066***	0.003		
<i>EBDA_t * Service_t</i>	?					-0.114***	0.000
<i>Net_Income_{t-1}</i>	+	-0.062***	0.000	-0.062***	0.000	-0.060***	0.000
<i>DACC_{t-1}</i>	?	-0.181***	0.000	-0.181***	0.000	-0.180***	0.000
<i>Observations</i>		74,319		74,319		74,319	
<i>R²</i>		0.35		0.35		0.36	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Variable definitions:

Variable	Definition
Net_Income_t	Net income in year t, deflated by lagged total assets.
Net_Income_{t-1}	Net income in year t-1, deflated by lagged total assets.
$DACC_t$	Discretionary accruals in year t from equation (1)
$DACC_{t-1}$	Discretionary accruals in year t-1 from equation (1)
$EBDA_t$	Earnings before discretionary accruals in year t, measured as net income in year t less discretionary accruals.
$Sophisticated_t$	Dummy variable equal to 1 if the charity has above-median restricted funds within its respective nonprofit classification, and 0 otherwise.
$Endowment_t$	Dummy variable equal to 1 if the charity has above-median endowment fund ratio (end of year endowment fund divided by total funds) within its respective nonprofit classification, and 0 otherwise.
$Service_t$	Dummy variable equal to 1 if the charity has above-median programme service revenue to total revenue within its respective nonprofit classification, and 0 otherwise.

The heightened government oversight is associated with lower financial reporting aggressiveness through accruals-based earnings management (Koreff et al., 2019).

The results of equation (3.5) are tabulated in the third set of results of Table 3.6, illustrating that more service-oriented charities are more likely than their charitable counterparts to manipulate the bottom-line earnings through accruals-based earnings management. Specifically, the coefficient on the interaction of service-oriented charities with $EBDA$ is significantly negative (coefficient -0.114; $p=0.000$), suggesting that more service-oriented nonprofits are more likely to manipulate earnings using discretionary accruals than less service-oriented the charitable nonprofits.

The increased propensity of accruals-based earnings management is consistent with the notion that the demand for financial reporting increases as the donor's direct involvement with the recipient organisation decreases (Gordon and Khumawala, 1999; Balsam and Harris, 2013) therefore accruals-based management is more likely where financial statements are less referred to relative to other information sources. *"In contrast, supporters who are recipients of nonprofit services can directly evaluate the quality of those services and, thus, have less demand for financial reporting"* (Balsam and Harris, 2013). As financial statements become more relevant for charitable nonprofits with a bigger donor-recipient separation, the accounting-based manipulation may be less desirable due to its detectability through financial

statements. On the contrary, the more service-oriented charities have diminished demand for the financial statements due to an indistinct donor-recipient separation as they would have other ways to get the information of a charity's performance. There is a common belief that managers prefer accrual-based management compared to real earnings management as the potential consequences could be worse for real manipulation (e.g. Graham et al., 2005; Gunny, 2005; Zang, 2011; Kothari et al. 2015). A low donor-beneficiary separation would suggest an aversion to real manipulation, with a potentially larger impact on services and closer scrutiny by the beneficiaries, a large portion of whom is also its donors. Another possible explanation could be that the donations from small donors are hard to accrue, hence the opportunity for the income-based earnings management may be less available to charitable nonprofits. On the other hand, when there are large contracts, where the payment periods can shift between periods there is a more likelihood of subjectivity in income recognition.

3.6.2 Real accounts manipulation

The hypotheses relating to real manipulation are in relation to managerial discretion in levels of fundraising spending. The fundraising expenses are not directly related to achieving the main purpose of a charity, therefore are comparable to discretionary expenses which according to both for-profit and nonprofit literature are prone to manipulation.

Hypothesis 6 examines fundraising expenses as a tool to manage earnings, either upwards or downwards in pursuit of a zero-profit benchmark. Following Eldenburg et al. (2011) I compute "projected income" which signifies what net income would be if the fundraising expenses in year t were the same as in year $t-1$. This is calculated by computing net income before fundraising expense of the same year t and then adding back the reported fundraising costs in year $t-1$. The purpose for computing projected income is to categorise the ranges which are mainly above and below benchmark net income ranges. A charity is classified within the "benchmark range" if its projected income deflated by lagged total assets falls in interval $[0, 0.04)$. If a charity has a large enough deficit in year t that by substituting fundraising expenses in $t-1$ for the fundraising expenses in year t will not push it to the benchmark range this is classified as "far below". The projected income of a "far below" charity is below zero by an amount more than the fundraising expenses in $t-1$ and therefore the real expense

management of fundraising costs on its own will not suffice to enter the desired benchmark range. In other words, even if the fundraising expense were to be brought down to zero, the firm would not enter the benchmark range. The neighbouring bins of the benchmark range is “below” on its left and a downward adjustment to the expense can help to migrate the firm into the benchmark range.

Following Eldenburg et al. (2011), I hypothesise that the firms in the “below” range have incentives to push their way into the benchmark range. They achieve the desired range by managing fundraising expenses downwards in relation to their fundraising expenses in t-1. Likewise, the firms in “above” range have incentives to migrate into the benchmark range from the right. These firms would have incentives in achieving the benchmark range by managing fundraising expenses upwards in relation to their fundraising expenses in t-1.

Therefore, for H6⁶⁵, I expect managers to decrease fundraising expenses in relation to the previous year so that the reported net income is more positive than projected. Likewise, I expect managers to increase fundraising expenses in relation to the previous year so that the reported net income is less positive than projected, in order to avoid additional scrutiny due to a large bottom line. Regarding “far below” firm years, following Eldenburg (2011), I have no directional prediction. These nonprofits that have their projected income far below the benchmark range are faced with two possible choices, a) come very close to the benchmark range by deferring the fundraising expenses as much as possible, despite the fact they are unable to reach zero earnings even if the fundraising cost on their own are completely removed, b) “Take a bath” by bringing forward some discretionary expenses from a future period to the current period, so that the expenditure is reduced and hence income becomes larger in a future period.

I run the following regression to test the hypothesis:

$$\Delta FR_{it} = \alpha_0 + \beta_1 Decrease_{it} + \beta_2 Increase_{it} + \beta_3 NoPred_{it} + \beta_4 Log(Assets_{it-1}) + \beta_5 \Delta Income_{it} + \sum_{j=1}^{12} \beta_{5+j} Year_j + \varepsilon_{it} \quad (3.6)$$

where:

⁶⁵ For easy reference H6 is restated here:
When nonprofits' earnings are expected to be below (above) the benchmark, nonprofits will decrease (increase) spending on fundraising activities.

ΔFR_{it} = change in fundraising expenses from t-1 to t, deflated by lagged total assets;

Decrease = 1 if projected income is below benchmark range ([0, 0.04)) by an amount lower than previous year's fundraising expense, 0 otherwise;

Increase = 1 if projected income is above benchmark range ([0, 0.04)) by an amount larger than previous year's fundraising expense, 0 otherwise;

NoPred = 1 if projected income is below benchmark range ([0, 0.04)) by an amount larger than previous year's fundraising expense, 0 otherwise;

$\text{Log}(\text{Assets}_{it-1})$ is log of total assets in year t-1;

$\Delta \text{Income}_{it}$ is change in total income (similar to revenues in for-profit firms) from t-1 to t, deflated by lagged total assets; and

$\text{YEAR}_j = 1$ if observation is in year j of the sample, 0 otherwise;

All other variables are as previously defined.

The independent primary indicator variables of interest are *Increase*, *Decrease* and *NoPred*. *Increase* and *Decrease* in the multivariate regression model represent the charity years for which I expect management to manage fundraising expenditure upwards and downwards respectively (corresponding to the "above" and "below" classifications discussed above). The *NoPred* variable indicates the firm-years which are "far below" the benchmark range and hence the direction of manipulation cannot be predicted. Following the extant literature, I use the log of total assets to control for the charity size and ΔSales to control for changes in ordinary operations from t-1 to t. If hypothesis 6⁶⁶ is supported, I expect a negative sign for β_1 and a positive sign for β_2 . The results are presented in Table 3.7.

Consistent with the hypothesis, the charities with negative (positive) projected net income decrease (increase) fundraising expenses to achieve the target benchmark net income. The coefficient estimate on *Decrease* is -0.091 and significant at the 1% significance level.

Table 3.7: Test of real manipulation in charities

⁶⁶ For easy reference H6 is restated here:

When nonprofits' earnings are expected to be below (above) the benchmark, nonprofits will decrease (increase) spending on fundraising activities.

The table presents results of the regression of the form:

$$\Delta FR_{it} = \alpha_0 + \beta_1 Decrease_{it} + \beta_2 Increase_{it} + \beta_3 NoPred_{it} + \beta_4 Log(Assets_{it-1}) + \beta_5 \Delta Income_{it} + \sum_{j=1}^{12} \beta_{5+j} Year_j + \varepsilon_{it} \quad (3.6)$$

Independent Variables	Prediction	Coeff	P-Value
<i>Intercept</i>		0.082***	0.000
<i>Decrease_t</i>	-	-0.100***	0.000
<i>Increase_t</i>	+	0.022***	0.000
<i>NoPred_t</i>	?	-0.012***	0.000
<i>Log(Assets_t)</i>		-0.006***	0.000
<i>ΔIncome_t</i>		0.013***	0.000
<i>Year Indicators</i>		Yes	
<i>Observations</i>		86,777	
<i>R²</i>		0.13	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Variable definitions:

Variable	Definition
<i>ΔIncome_t</i>	Change in Income from year t-1 to t, deflated by lagged total assets.
<i>Log(Assets_t)</i>	Natural logarithm of total assets in year t.
<i>Decrease_t</i>	Dummy variable equal to 1 if projected income is below benchmark range ([0, 0.04)) by an amount lower than previous year's fundraising expense, and 0 otherwise.
<i>Increase_t</i>	Dummy variable equal to 1 if projected income is above benchmark range ([0, 0.04)) by an amount higher than previous year's fundraising expense, and 0 otherwise.
<i>NoPred_t</i>	Dummy variable equal to 1 if projected income is below benchmark range ([0, 0.04)) by an amount larger than previous year's fundraising expense, and 0 otherwise.

The coefficient estimate on *Increase* is 0.021 and significant at the 1% level. Similarly, although the propensity is lower than for the charities with small deficit, the charities far below the benchmark range also decrease their fundraising expenses, presumably in their effort to reduce their deficit. The results from Equation (3.6) represent that a charity with higher level of net income will increase fundraising expenses, in its effort to enter the benchmark range.

To test H7, H8 and H9⁶⁷ I include an interaction term in my empirical model by examining the interaction of *Increase*, *Decrease* and *NoPred* with indicator variables representing sophisticated funders, endowment funds, and service-oriented funding. As discussed earlier the sophisticated donors have a detailed direct scrutiny or monitoring because of higher than median level of restricted donations. An increased level of restricted donations implies increased monitoring by the donors relative to the nonprofits funded by unrestricted income from less sophisticated donors. I expect such interaction will decrease the likelihood of REM employing the fundraising expenses. I interact *Decrease*, *Increase* and *NoPred* with *Sophisticated* as well as *Endowment* and *Service* in the following models:

$$\Delta FR_{it} = \alpha_0 + \beta_1 Decrease_{it} + \beta_2 Increase_{it} + \beta_3 NoPred_{it} + \beta_4 Sophisticated_{it} + \beta_5 Decrease_{it} * Sophisticated_{it} + \beta_6 Increase_{it} * Sophisticated_{it} + \beta_7 NoPred_{it} * Sophisticated_{it} + \beta_8 Log(Assets_{it}) + \beta_9 \Delta Income_{it} + \sum_{j=1}^{12} \beta_{9+j} YEAR_j + \varepsilon_{it} \quad (3.7)$$

$$\Delta FR_{it} = \alpha_0 + \beta_1 Decrease_{it} + \beta_2 Increase_{it} + \beta_3 NoPred_{it} + \beta_4 Endowment_{it} + \beta_5 Decrease_{it} * Endowment_{it} + \beta_6 Increase_{it} * Endowment_{it} + \beta_7 NoPred_{it} * Endowment_{it} + \beta_8 Log(Assets_{it}) + \beta_9 \Delta Income_{it} + \sum_{j=1}^{12} \beta_{9+j} YEAR_j + \varepsilon_{it} \quad (3.8)$$

$$\Delta FR_{it} = \alpha_0 + \beta_1 Decrease_{it} + \beta_2 Increase_{it} + \beta_3 NoPred_{it} + \beta_4 Service_{it} + \beta_5 Decrease_{it} * Service_{it} + \beta_6 Increase_{it} * Service_{it} + \beta_7 NoPred_{it} * Service_{it} + \beta_8 Log(Assets_{it}) + \beta_9 \Delta Income_{it} + \sum_{j=1}^{12} \beta_{9+j} YEAR_j + \varepsilon_{it} \quad (3.9)$$

Where all variables have been previously defined.

The first set of results in Table 3.8 are from Equation (7). Consistent with H7⁶⁸, the coefficient on the interaction of the indicator variable *Sophisticated* with *Decrease* is

⁶⁷ For easy reference, H7, H8 and H9 are restated here:

H7: When nonprofits' earnings are expected to be above (below) the benchmark, nonprofits with more sophisticated funders are less likely to increase (decrease) spending on fundraising activities than nonprofits with less sophisticated funders.

H8: When nonprofits' earnings are expected to be above (below) the benchmark, nonprofits with high endowment funding are less likely to increase (decrease) spending on fundraising activities than other nonprofits.

H9: When nonprofits' earnings are expected to be above (below) the benchmark, nonprofits that are service-oriented are less likely to increase (decrease) spending on fundraising activities compared to charitable nonprofits.

⁶⁸ For easy reference H7 is restated here:

H7: When nonprofits' earnings are expected to be above (below) the benchmark, nonprofits with more sophisticated funders are less likely to increase (decrease) spending on fundraising activities than nonprofits with less sophisticated funders

significantly positive (coefficient 0.016; $p=0.002$). The coefficient of the interaction with *Increase* is significantly negative (coefficient -0.007; $p=0.001$). These results suggest that a charity funded predominantly by sophisticated donors, who place restrictions on the use of their funds, is less likely to employ real earnings management using fundraising expenses from either side of the benchmark. The coefficient on the interaction of *Sophisticated* with *NoPred* is not significant, indicating that the sophistication of a charity's funders does not affect the willingness of nonprofit managers, when their projected income is far below the benchmark range.

The second set of results in Table 3.8 relates to endowment funds (equation 3.8). Consistent with H8⁶⁹, the coefficient on the interaction of the indicator variable *Endowment* with *Decrease* is significantly positive (coefficient 0.07; $p=0.000$) and that with *Increase* is significantly negative (coefficient -0.013; $p=0.000$). This suggests that a charity funded predominantly through endowment income, from the donors who also tend to be sophisticated, placing restrictions on the use of funds, is less likely to employ real earnings management using fundraising expenses from either side of the benchmark. The coefficient on the interaction of *endowed charity* with *NoPred* is significantly positive, indicating that the endowment charities are less likely to manage fundraising expenses downwards to reduce large deficits. The final hypothesis refers to the impact of interaction with service-oriented nonprofits, which by design have a higher level of direct scrutiny due to a low donor-beneficiary distance. On the contrary, the donors of more charitable nonprofits are predominantly disparate donors who are not the beneficiaries of the charity. Hence, the reliance on a more detailed study of the financial statements is expected relative to their more service-oriented counterparts that have other direct sources of information of a charity's services. I interact *Decrease*, *Increase* and *NoPred* with a service-oriented charities dummy, with the expectation that real earnings management is less detectable through financial statements than AEM.

⁶⁹ For easy reference H8 is restated here:

When nonprofits' earnings are expected to be above (below) the benchmark, nonprofits with high endowment funding are less likely to increase (decrease) spending on fundraising activities than other nonprofits.

Table 3.8: Test of real manipulation in charities related to type of funders

The table presents results of regressions of the form:

$$\begin{aligned} \Delta FR_{it} = & \alpha_0 + \beta_1 Decrease_{it} + \beta_2 Increase_{it} + \beta_3 NoPred_{it} \\ & + \beta_4 Sophisticated (Endowment or Service)_{it} + \beta_5 Decrease_{it} \\ & * Sophisticated (Endowment or Service)_{it} + \beta_6 Increase_{it} \\ & * Sophisticated (Endowment or Service)_{it} + \beta_7 No_Pred_{it} \\ & * Sophisticated (Endowment or Service)_{it} + \beta_8 Log(Assets)_{it} + \beta_9 \Delta Income_{it} \\ & + \sum_{j=0}^{12} \beta_{9+j} YEAR_j + \varepsilon_{it} \end{aligned} \quad (3.7, 3.8, 3.9)$$

		<i>Sophisticated</i>		<i>Endowment</i>		<i>Service</i>	
Independent Variable	Prediction	Coeff	P-Value	Coeff	P-Value	Coeff	P-Value
<i>Intercept</i>		0.081***	0.000	0.084***	0.000	0.087***	0.000
<i>Decrease_t</i>	-	-0.109***	0.000	-0.110***	0.000	-0.098***	0.000
<i>Increase_t</i>	+	0.025***	0.000	0.023***	0.000	0.030***	0.000
<i>NoPred_t</i>	?	-0.011***	0.000	-0.014***	0.000	-0.020***	0.000
<i>Sophisticated_t</i>	-	-0.001	0.636				
<i>Endowment_t</i>	-			-0.002	0.473		
<i>Service_t</i>	?					-0.004*	0.073
<i>Decrease_t * Sophisticated_t</i>	+	0.016***	0.002				
<i>Increase_t * Sophisticated_t</i>	-	-0.007***	0.001				
<i>NoPred_t * Sophisticated_t</i>	?	-0.002	0.355				
<i>Decrease_t * Endowment_t</i>	+			0.065***	0.000		
<i>Increase_t * Endowment_t</i>	-			-0.013***	0.000		
<i>NoPred_t * Endowment_t</i>	?			0.009***	0.000		
<i>Decrease_t * Service_t</i>	?					-0.001	0.901
<i>Increase_t * Service_t</i>	?					-0.015***	0.000
<i>NoPred_t * Service_t</i>	?					0.014***	0.000
<i>Log(Assets_t)</i>		-0.006***	0.000	-0.006***	0.000	-0.006***	0.000
<i>ΔIncome_t</i>		0.013***	0.000	0.012***	0.000	0.012***	0.000
<i>Year Indicators</i>		Yes		Yes		Yes	
<i>Observations</i>		86,777		86,777		86,777	
<i>R²</i>		0.13		0.13		0.13	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Variable definitions:

Variable	Definition
$\Delta Income_t$	Change in Income from year t-1 to t, deflated by lagged total assets.
$Log(Assets_t)$	Natural logarithm of total assets in year t.
$Sophisticated_t$	Dummy variable equal to 1 if the charity has above-median restricted funds within its respective nonprofit classification, and 0 otherwise.
$Endowment_t$	Dummy variable equal to 1 if the charity has above-median endowment fund ratio (end of year endowment fund divided by total funds) within its respective nonprofit classification, and 0 otherwise.
$Service_t$	Dummy variable equal to 1 if the charity has above-median programme service revenue to total revenue within its respective nonprofit classification, and 0 otherwise.
$Decrease_t$	Dummy variable equal to 1 if projected income is below benchmark range ([0, 0.04)) by an amount lower than previous year's fundraising expense, and 0 otherwise.
$Increase_t$	Dummy variable equal to 1 if projected income is above benchmark range ([0, 0.04)) by an amount higher than previous year's fundraising expense, and 0 otherwise.
$NoPred_t$	Dummy variable equal to 1 if projected income is below benchmark range ([0, 0.04)) by an amount larger than previous year's fundraising expense, and 0 otherwise.

The results appear in the final columns of table 3.8. The coefficient on the interaction of the indicator variable, *Service*, with *Decrease* is not significant and that with *Increase* is significantly negative (coefficient -0.015; $p=0.000$) suggesting that a service-oriented charity is less likely to employ real earnings management to increase fundraising expenses to reduce net income. It may be that a service-oriented charity would be more concerned to shift its deficit into the benchmark than reducing its income employing real activities management; avoiding it looking financially unviable to a contract-providing authority. On the contrary, the coefficient on the interaction of service-oriented charity with *NoPred* is significantly positive (coefficient 0.014; $p=0.000$). There are two possible explanations to explain this. It may be an indication that a service-oriented charity is less likely to manage its fundraising costs than its charitable nonprofit counterpart to move towards the benchmark range when it makes a very large deficit, like in the case of a small deficit. Alternatively, it may take a “bath” by employing REM to increase the expenses further by bringing them forward (Eldenburg et al., 2011), hence shifting discretionary expenditures from future periods to the current period. Such practice can potentially improve the chances of achieving the benchmark in the next period, when the probability to convert loss into surplus would otherwise be remote.

3.7 Robustness tests

I run the estimation regression using Kothari (2005), by adding return on assets for the current year (ROA_t) and previous year (ROA_{t-1}) as a control variable for the effect of performance on measured discretionary accruals. I run the regressions by industry and year and the results are essentially similar using either the current year (ROA_t) or the previous year (ROA_{t-1}) to those reported in the main analysis.

I run all regressions, adding log of total assets and change in net income to the equation as control variables too. The results are broadly similar with the coefficient on EBDA as -0.44 in the main regression and a significantly positive result on change in net income with the coefficient of 0.16. The coefficient on log of total assets is not significant. For the interaction regressions, although the coefficient on sophisticated charity is not significant, the endowment charity interaction remains significantly positive with the coefficient 0.044, supporting a weaker negative relationship between DACC and EBDA for an endowment charity. The results for more the more service-oriented charities are also similar with a significantly negative interaction term coefficient of -0.1, confirming a higher degree of accrual manipulation for more service-oriented charities.

In addition to the above, I run regressions using continuous variables, rather than using dichotomous variables as proxies for sophistication and donor-beneficiary separation in the main analysis. The continuous variable for sophistication is the restricted funds as a ratio of total funds, and programme service revenue as a ratio of total income for donor-beneficiary separation. The results are all broadly similar to the results tabulated for the main analysis. The result for restricted funds interaction is significantly positive and for programme service revenue, it is significantly negative.

To address a possible mechanical relation between discretionary accruals and EBDA, following Leone and Van Horn (2005) and Vansant (2016), I substitute EBDA with EBAE i.e. earnings before total accrual expenses. To calculate EBAE I add back total accruals to net income. The results are similar to those for the main analysis. With DACC as the dependent variable, the coefficient on EBAE is -0.45. By employing EBAE-Sophisticated interaction, the coefficient is .046 and EBAE-Endowment interaction is 0.072, confirming a mitigating impact by donor sophistication through restriction or endowment. Similarly the coefficient on EBAE-Service interaction is -.10

alluding to a higher likelihood for a service-oriented charity to manage earnings using accruals-based earnings management techniques.

In my main study to test real earnings management hypotheses, following earlier studies (e.g. Degeorge, 1999; Leone and Van Horn, 2005), I calculated bin widths for net income using the formula $2(IQR)n^{1/3}$ and based on which the bin width 0.005, as reported in the main study. However, I also impose the bin widths of 0.004 and 0.006. The results are quite similar to those for all REM hypotheses.

3.8 Conclusion

This study investigates both accrual and real manipulation in charities around a significant benchmark: zero profits, with a focus on charity types. I find that nonprofits avoid large surplus and deficits and in so doing employ real and accrual-based earnings management techniques. The propensity and method of such manipulation depends on sophistication and donor-beneficiary distance. I find evidence that charities funded by sophisticated donors or those with large endowment funds, are less likely to manage earnings using accounting-based or real activities-based techniques.

I first investigate whether UK nonprofits use discretionary accruals to manage earnings to a small surplus benchmark and whether the likelihood of earnings management in this setting is affected by donor sophistication and donor-beneficiary separation. I find that UK nonprofits manage earnings towards a small surplus benchmark after observing pre-managed earnings on either side of the benchmark. The evidence is consistent with both the zero-profit (Bouwens et al, 2004; Leone and Van Horn, 2005; Ballantine et al., 2007; Verbruggen and Christiaens, 2012;) and loss avoidance (e.g. Leone and Van Horn, 2005) hypotheses, with an amplified appetite for loss avoidance than a large surplus aversion. This is consistent with the earlier literature and can be explained in light of resource dependency theory. The funders may consider charities with large surpluses as less needy of their funds, hence prompting managers to appease funders through earnings management.

I also find that charities with sophisticated funders are less likely to engage in earnings management behaviour to reach this zero-profit benchmark. In addition, charities that are mostly funded by endowments are less likely to manipulate bottom-line income. I also investigate manipulation in service-oriented charities that are dependent mainly

on public support through programme revenue from government grants or contracts. I find these charities to be less manipulative in targeting a small surplus employing real accounts manipulation (i.e. fundraising costs). This could be because a low donor-recipient separation would make abnormal changes to fundraising costs more noticeable and hence reduce their preference as a tool for earnings management. This may also be because such charities resort mainly to accrual manipulation techniques as a substitute during the year. Since accrual manipulation is employed at year-end, it remains less noticeable for the funders who, because of having access to several other sources of information, are less likely to read the financial statements at year-end compared to other charities.

Overall, the oversight for real spending appears better for service-oriented charities, presumably, due to a low donor-recipient separation, through better supervision of charity funds. Possibly, the reduced desire for real accounts manipulation points to a better awareness of the adverse effects of this on future performance compared to the accounting-based earning management.

There are some differences between small and large charities too; larger charities are less likely to manage earnings by altering fundraising costs. Given that the size of a firm is used as a proxy of management sophistication in prior literature, these findings support the argument that real manipulation is seen as more dysfunctional, hence sophisticated donors and managers are comparatively more wary of its use.

This study has a multitude of implications at various levels. As the focus of the study is on larger UK charities, it covers a very large portion of the sector which includes all charities that are audited. Hence, there are economically important implications for the audit profession through understanding the incentives for manipulation vis-à-vis funding types. This can potentially guide auditors at the audit plan stage in deciding on an effective balance between analytical review, tests of control and substantive testing. Similarly, given that one in four adults donate to the sector in the UK, this study is relevant to ensure that the funders are not unduly fixated on the bottom line figure; rather, their main concern should be on the effectiveness, efficiency and stewardship of a charity utilising a multitude of information sources. A large army of volunteers also have the right to be informed of the reporting misgivings in the sector. This study also informs donors to consider placing restrictions on their funds in order for managers to

be more careful to maintain a good financial reporting quality. In addition, this study also has implications for the donors of less service-oriented charities showing that these charities could compromise on financial reporting quality in pursuit of a target bottom-line figure employing a more costly method of earnings management, the real activities manipulation.

3.9 Limitations and future research

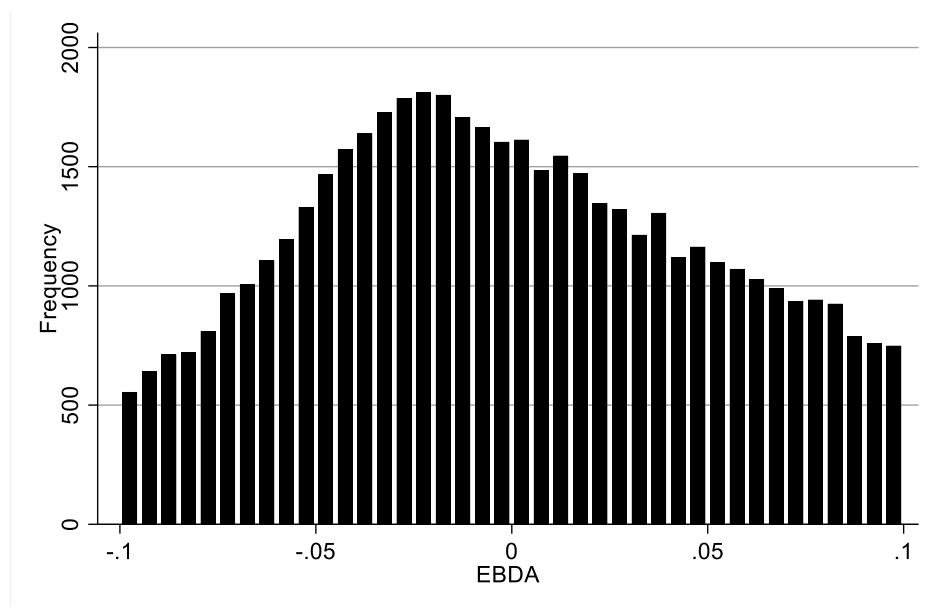
As with all research, there are limitations in this study. For example, there may be certain firms that are temporarily targeting a particular funding source whilst making accounting or expense-related decisions, hence cannot practically have typical attributes of its particular taxonomy. Similarly, a complex mix of funding from programme, fundraising, restricted, and unrestricted income sources could make a manager's job more difficult to predict than a manager of a nonprofit that belongs to a clearly defined classification.

Better understanding of the interplay between accruals-based and real activities management would make a useful addition to this work. Similarly, the addition of a high quality audit as a monitoring mechanism as a control variable will help in understanding management's behaviour purely due to donor monitoring. Furthermore, the study of the impact of real activities and accruals-based earnings management on future performance would have important policy implications. For-profit earnings management research points to a more severe impact on a firm's future health when it engages in real manipulation (e.g. Cohen and Zarowin, 2010; Kim and Sohn, 2013). Empirical evidence to test the same for nonprofits will have implications for several stakeholders. Accounting-based manipulation that is found to be prevalent in service-oriented nonprofits may be lesser of the evils, only if it could be demonstrated that its impact is less severe on the future services of a charity. This could be linked with a corporate governance study of charities to assess whether highly paid CEOs prefer one type or the other or both.

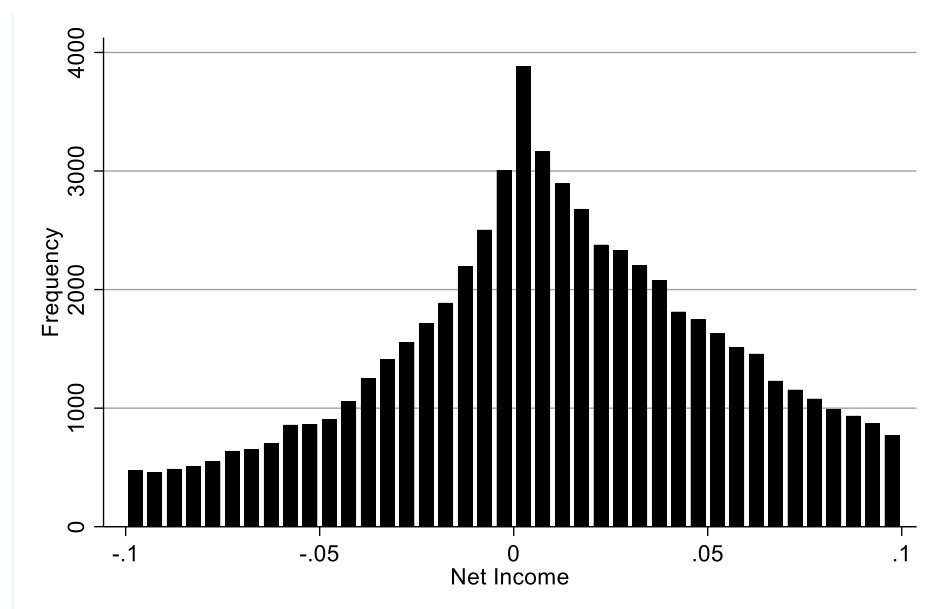
Appendix 3.1: Figures

Figure 3.1: EBDA and net income histograms

Panel A: Histogram showing distribution of earnings before discretionary accruals (EBDA) of nonprofit sample



Panel B: Histogram showing distribution of Net Income of nonprofit sample



Appendix 3.2: International Classification of Nonprofit Organizations (ICNPO)

Group	Description
Group 1	Culture and recreation
Group 2	Education and research
Group 3	Health
Group 4	Social services
Group 5	Environment
Group 6	Development and housing
Group 7	Law, advocacy and politics
Group 8	Philanthropic intermediaries and voluntarism promotion
Group 9	International
Group 10	Religion
Group 11	Business and professional associations, unions
Group 12	Not elsewhere classified

Chapter 4: Study on Expense Misclassification: Evidence from UK Charities

4.1 Introduction

The UK charity sector is going through a period of strained financial resource availability. Various challenges are currently faced by charities to guarantee them a safely funded space for themselves. Increased funding pressures with long years of austerity culminating in unprecedented strain on government spending following the coronavirus outbreak in 2020⁷⁰, and a generally reduced public trust in the sector have exacerbated the uncertainty in reliably raising funding. In 2019, the fundraising income and spending declined by £300 million, moreover, the Charity Commission has warned of the worsening accounting quality of UK charities⁷¹ for the third consecutive year. For the first time, the drop has been described as “significant” by the Commission. Recently, Nigel Davies, the Charity Commission head of accountancy services stated that *‘The public want and deserve to know how charities spend their money, so this deterioration in the quality of accounts is of serious concern’*.⁷² The drop in fundraising income when accompanied by a fall in fundraising expenses begs the question whether expenses are being hidden to convince the donors of the continued legitimacy of the relevant charities.⁷³ Although the largest fundraising charities’ total income has increased slightly over the last two years, since 2014/15 the annual income growth has been on a downward trajectory.⁷⁴

⁷⁰ A high degree of social disruption has impacted on the delivery of and demand for the activities of charities, the availability of staff for work, and levels of illness across society which will affect the beneficiaries of charities. There are therefore potential implications for charity income, expenditure and commitments. In some cases the implications may be so severe as to cast doubt upon a charity’s financial sustainability. <https://charityscorp.org/media/648486/sorp-covid-19.pdf>

⁷¹ <https://www.gov.uk/government/publications/accounts-monitoring-review-public-reporting-on-charity-reporting-in-their-trustees-annual-report-and-accounts>

<https://www.thirdsector.co.uk/fundraising-income-spending-among-best-known-charities-down-300m-last-year/fundraising/article/1581691>

⁷² <https://www.gov.uk/government/collections/accounts-monitoring-charity-commission#reports-published-in-2018>

⁷³ <https://fundraising.co.uk/2019/06/07/43-of-top-100-fundraising-charities-saw-income-decrease-in-2017-18/>

⁷⁴ Report by Cathy Pharoah and Philanthropy Research at Cass Business School.

Given the significance and reach of the sector, with over 180,000 registered charities in the UK⁷⁵ if anything appears out of the norm with respect to a specific charity, this may impact future funding. There are various metrics to assess the effectiveness and efficiency of charities, both qualitatively and quantitatively. One such quantitative set of metrics to assess efficiency is the expense ratios of charities. Expenses in charities are broadly classified as programme (or referred to as charitable activities expenses), fundraising and administrative. Programme related expenses are associated with fulfilling the recognised objectives of a charity; fundraising costs are expended for generating income e.g. individual and corporate donations and government grants, and administrative expenses amount to the costs for managing the entity (Krishnan and Yetman, 2010). In the UK charity data, it is easier to identify the reported fundraising and programme spending but administrative costs are not separately presented as they are embedded within the fundraising and charitable expenses.

The commonly used expense ratios are the 1) fundraising ratio – fundraising costs as a percentage of total expenses or total income, 2) charitable activities (programme) ratio – charitable activities costs as a percentage of total expenses or total income, and 3) administration costs ratio - support and governance costs as a ratio of total costs (e.g. Gordon et al., 2006, 2009; Krishnan et al., 2006; Connolly et al., 2013). The programme related expenses, which are favourable expenses from donors' and media's perspective, reflect those expenses that are directly associated with achieving the charitable cause for which a charity is registered with the Charity Commission. Anecdotal evidence suggests that the public, as potential beneficiaries and contributors to UK charities, and the Charitable Commission are indeed concerned with this ratio. For example, in 2017 the Charity Commission issued a stark warning to a Derbyshire charity after it emerged that the charity had spent just 3 percent of its total expenditure on charitable activities in 2014-15; the majority of the expenditure was on fundraising and other expenses.⁷⁶ The Charity Commission has raised concerns about the misallocation of expenses in a very large number of charities⁷⁷, but

⁷⁵ 183,333 charities – 167,772 main and 15,561 connected charities; Charity Commission register accessed 26 February 2020

⁷⁶ <https://www.channel4.com/news/factcheck/how-much-charities-spend-good-causes>.

⁷⁷ The commission found that only 3 (4%) of the charities had a reasonable explanation for their high level of governance costs. The governance costs should only include audit, legal and other constitutional and statutory related expense, hence it is unlikely that they would be seen as excessive by donors.

to my knowledge no extant study exclusively examines the existence or extent of misclassification of expenses in the UK charity sector setting.

It is important to note that fundraising costs cannot always be “unfavourable”. Their inherent purpose is to increase the information for the donors, hence reducing their information costs. Although fundraising costs increase the level of contributions directly by reducing information costs for donors, they also decrease contributions by increasing the price of giving (e.g. Weisbrod and Dominguez, 1985; Posnett and Sandler 1989). This is because high fundraising costs can lead funders to believe that less is ending up spent on their intended cause.

A significant body of research points to the association between the programme ratio and future donations. Various studies model donation receipts as a function of charity expense type such as fundraising or programme (charitable) expenditure. A positive association has been reported by a number of studies between the programme ratio and ensuing donations (e.g. Weisbrod and Dominguez 1986; Tinkelman 1998, 1999; Greenlee and Brown 1999; Okten & Weisbrod, 2000; Buchheit & Parsons, 2006; Amin and Harris, 2017; Parsons’ et al., 2017;), whereas there is evidence that higher fundraising costs lead to reduced grant amounts (Ashley and Faulk, 2010).

The cost to a donor of purchasing one dollar’s worth of an organisation’s output is an important consideration for stakeholders.⁷⁸ Since the introduction of Charity Statement of Recommended Practice (SORP) 2005, the programme ratio as calculated from the face of the Statement of Financial Activities (SOFA)⁷⁹ increased significantly (Connolly et al., 2013). This points to the possibility that managers may manipulate accounting numbers on the face of the SOFA as average users may not look at the notes to the accounts to investigate allocations of support costs into charitable activities and fundraising costs. As far as donors are concerned their main

https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/477927/amr_high_governance_costs.pdf

⁷⁸ According to Posnett and Sandler (1989), price is defined as $1/(1-(f+a))$, Where f and a are the proportions of total expenditure earmarked to fundraising and administration, respectively. If, for example, $f+a=0.2$, a donor will be required to contribute £1.25 to generate an increase in charitable output of £1, and this is the implicit price of giving.

⁷⁹ The Statement of Financial Activities is akin to income statement as in for-profit firms. It presents all incoming resources and resources expended by the charity in the year on all its funds.

interest is in knowing how much every pound they donate is spent on charitable activities (Parsons, 2003).

To add to the problem, there is inconsistency across charities in what they classify as fundraising and programme spending, and more typically so for the allocation of joint costs which are mainly made up of administrative or marketing expenditure. A common example is the variation across charities in allocation of advertising mailshot costs which some charities would argue also educate the donors, thus fulfilling the identified charity objective. This often results in arbitrary or subjective allocation of such costs between fundraising and programme spending. This allocation depends on how much of such expense can be justified as fulfilling the primary objectives for which a charity was registered with the Charity Commission. Up to 30% of charities have differences in their reported performance, solely due to accounting choices (Sargeant & Jay, 2004).

The donors are specifically interested in spending on charity administration as a percentage of total expenditure and fundraising costs as a percentage of total expenditures (e.g. Tinkelman, 1999; Margolis, 2001; Parsons' et al., 2017).

There is an argument that the objective of a charity should not be a mere reduction in fundraising costs, and fundraising costs should not be viewed unfavourably if they contribute to marginal productivity, however small it may be. In other words if \$1 of fundraising expense results in \$1 of additional revenue (e.g. Steinberg, 1991; Young and Steinberg, 1995) then such fundraising cost should not be avoided by a charity for the sake of being seen as efficient. Although there is no legal limit imposed on fundraising costs as a percentage of income, either in the US or the UK, there is considerable public interest (Sargeant & Kähler, 1999). Donors target certain minimum levels of donations as “reasonable” to end up for the core charitable causes. However they suspect that the amounts shown by nonprofits understate their fundraising costs (e.g. Harvey and McCrohan, 1988; Doble, 1990).⁸⁰ The perception of donors regarding the level of spending also impacts the likelihood that donors would donate to a

⁸⁰ Doble (1990) in a focus group study found that donors expect that ideally a minimum target of 75 percent of a nonprofit's donations should be spent for the causes for which a charity is formed. Harvey and McCrohan (1988), through their study of a US-wide study of workers report the link between perceived organisational efficiency and giving. They report that a figure of 60 percent may represent a threshold. However the majority of donors suspect that the actual programme spending may be less than 50 percent of total expenses (Doble, 1990).

particular charity (e.g. Glaser, 1994). In order to ensure an increase in donations, it is not enough that charities are efficient with their fundraising costs; the evidence suggests that they need to be seen to have low fundraising costs too. *'If knowledge of fund-raising efficiency is not effectively communicated to prospective donors, gift sizes equivalent to very low efficiency levels can be expected'* (Harvey and McCrohan, 1988, p. 21)

The incentives for charities to manipulate their financial statements differ from their for-profit counterparts. However, the financial results for charities could be consequential, hence worth managing from management's perspective (Jones and Roberts, 2006). The literature suggests that charities that depend on donations are more likely to manage their programme ratio favourably (e.g. Jones and Roberts, 2006; Krishnan et al., 2006; Keating et al., 2008). This is because the commonly implied objective of a charity is to maximise its revenues and charitable activities expenses whilst minimising the non-charitable expenses such as fundraising costs (Hansmann, 1980; Rose-Ackerman, 1980, 1996). Therefore I posit that charitable nonprofits (NFPs) (Balsam and Harris, 2013) would be more prone to misclassify their expenses from an unfavourable category (fundraising expenses) to the favourable category (charitable expenses) when compared to other types of nonprofits. Following the literature on managerial discretion over nonprofit financial reporting (Jones & Roberts, 2006; Keating et al. 2008; Krishnan & Yetman, 2011; Krishnan, Yetman, & Yetman, 2006; Yetman, 2001), I hypothesise that charities' management behave differently depending on the type of funders.

The first aim of this paper is to determine whether UK charities manipulate their version of the Income Statement, the SOFA to misclassify fundraising costs as charitable activities (programme expenses). The second aim of this research is to establish whether funders' sophistication mitigates the tendency of such misclassification. The third and the final aim of this paper is to investigate whether donor-beneficiary separation will lead charities' managers to misclassify their "unfavourable" expenses as "favourable" or charitable expenses. This paper further investigates whether unfavourable expense ratios exacerbate the tendency for such manipulation.

Using a sample of UK charities with income above £0.5m over a period of twelve years (2007 to 2018), I find significant impact of both sophistication and donor-beneficiary

separation in the expense misclassification behaviour. I find that the charities that receive higher than the median level of restricted income funding, within their respective charity classification, are less likely to misclassify their fundraising costs as charitable activities expenses. This can be explained by the fact that a sophisticated funder looks beyond just the reported numbers and an organisation is aware of this. On the contrary, an average donor is unable to detect misclassification and is keen to view seemingly reasonable levels of the expense ratios as “legitimate”. Therefore, the charities’ management are more likely to manipulate their expense ratios by misclassifying their fundraising expenses as charitable activities expenses.

To my knowledge there are no studies that investigate the misclassification between the two types of expenses in the charitable sector using a large dataset. The study makes two important contributions to the literature. Firstly, it contributes to the literature of misclassification of income statement items in for-profit organisations (e.g. McVay 2006; Fan et al., 2010; Fan and Liu, 2017) by examining the setting of UK charities. Secondly, it contributes to the limited literature on earnings manipulation in nonprofits (e.g. Ballantine, et al., 2007; Eldenburg et al., 2011).

The remainder of the paper is structured as follows. The next section presents a theoretical perspective and prior research in expense misclassification in charities, leading up to several empirically testable hypotheses. The following section describes the data, methodology and models in testing the hypotheses. This section is followed by the results section that presents the main findings of the study. The paper ends with the conclusion section.

4.2 Theoretical background

This paper studies misclassification of expenses by UK charity managers, using institutional and resource dependence perspectives rather than the more traditional economic theory perspective. This study considers institutional isomorphism and resource dependence theories that suitably explain motivations for expense misclassification within the nonprofit setting. These theories are closely associated and complementary. The standard economic model of agency theory explaining the agency-principal relationship is difficult to comprehensively apply to the distinctive non-market situation of nonprofits (e.g. Helmig et al., 2004). In light of interviews with charity finance directors in my earlier study (Essay 1), it is clear that the prevailing

motives for financial misreporting in nonprofits setting are not limited to the pursuit of personal economic gains, rather it is for a wider range of reasons, most of which are ultimately aimed at the preservation of an organisation's continued flow of income.

Institutional theory stresses on the external environment including state, society, and culture that can influence the behaviour of an organisation (DiMaggio and Powell 1983). 'Organizations which incorporate institutionalised myths are more legitimate, successful, and likely to survive' (Meyer and Rowan, 1977, p. 361). Nonprofit firms depend heavily on donations from the government, public and corporations and sometimes have a difficult job to convince the donors of their legitimacy which in many ways is a requisite for their survival. The environment of the firms deviating from expectations may therefore lead to them not being recognised as legitimate nonprofits (Meyer and Rowan, 1977).

An organisation is less likely to resist institutional pressures that constrain its action, if it is heavily dependent on the source of these pressures (Oliver 1991). Nonprofits depend on a diverse set of funding streams to sustain their operations (Besel et al., 2011), hence the pressures of often uncertain amounts of funding may be stronger in nonprofits than for-profit firms and such pressures may vary within the charitable sector depending on the sources of their funding. Legitimacy is critical for nonprofit organisations in their ability to secure vital resources (Bigelow and Stone, 1995). A nonprofit's need to satisfy the funders to legitimate its existence would depend on the sophistication and donor-beneficiary separation. Legitimacy is a generalised perception or assumption that the actions of an entity are '*within socially constructed system of norms, values, beliefs and definitions*' (Suchman, 1995, p. 574).

Nonprofits are expected to become isomorphic in their structures and processes (Ramanath, 2009). In their effort to fit in the socially constructed norms, I posit that all three processes of institutional isomorphism, as argued by DiMaggio and Powell (1983), namely mimetic, coercive, and normative would also shape the financial reporting behaviour of nonprofits. The seminal paper on institutional isomorphism by DiMaggio and Powell (1983) provides several elaborations that can be linked to the charitable sector. In fact they refer to the sector their paper too. According to them, the more uncertain the relationship between means and ends, the greater the extent to which an organisation will model itself after organisations it perceives to be successful.

External actors may induce an organisation to conform to its peers, through mimetic isomorphism, hence leaving less choice by nonprofits to faithfully represent their financial statements. I postulate that one explanation for nonprofits' manipulation of expense ratios is mimetic isomorphism where in the wake of uncertainty of their funding, they tend to mimic other established nonprofits as *'uncertainty is also a powerful force that encourages imitation'* (DiMaggio and Powell, 1983).

Coercive isomorphism is a more subtle and less explicit type that results from both formal and informal pressures from other organisations and society. For example despite being largely ceremonial, yet consequential, nonprofits are required to maintain accounts and hire accountants (DiMaggio and Powell, 1983) adhering to the rituals of conformity in the sector. It would therefore not be far-fetched to expect that nonprofits do not only draft financial statements in a particular way as required by the Charity Commission, but also conform to the norms and expectations in uncertain times on what those accounts should and should not look like. To enhance their legitimacy, organisations model themselves on other organisations in times of uncertainty and therefore a nonprofit is expected to legitimate itself by adopting the "ubiquity of certain structures" (DiMaggio and Powell, 1983) including showing "normal" expense ratios.

For Normative pressures, the third source of isomorphic organisation, change stems from professionalization. Professionalisation is the collective struggle of members of an occupation to define the conditions and methods of their work. In the nonprofit sector, where legal barriers to collusion do not exist, structuration⁸¹ may proceed even more rapidly (Larson, 1977; Collins, 1979; DiMaggio and Powell, 1983). Hence, I posit that charity sector accountants behave in a certain way that suits the environment and at times at the cost of their sceptic professional judgement because their *'futures are inextricably bound up by the organisation'* (DiMaggio and Powell, 1983, p.152), leaving them with a dilemma involving an impulsive choice between professional uprightness and organisational commitment. The charity sector financial statements, in general,

⁸¹ Structuration - According to Giddens (1984) the actions of humans, as agents, in their social contexts produce social structure. Humans are in a constant state of reflexive monitoring of their situation with a consistent potential for change.

are expected to have a significantly lower levels of fundraising costs compared to programme costs. Therefore, the charity accountants are expected to submit to this expectation, in their attempt to fulfil the needs of their employer charity. In doing so in some cases they may be compromising their professional integrity.

Correspondingly, according to resource dependence theory, a firm is constrained by the pressures that arise when it pursues resources, and the survival of the firm demands adjustments to its environment (Pfeffer and Salancik, 2003). Resource dependence theory posits that an organisation's operating strategy is influenced by expectations and preferences of its resource providers and it can also explain organisational actions that could sometimes be in pursuit of societal acceptance rather than economic performance being the primary motive (Pfeffer & Salancik, 1978; Drees & Heugens, 2013).

4.3 Literature review and hypotheses development

Regarding the approaches in raising income and expending resources, the extant literature points to budget maximisation and service maximisation. The objectives of a nonprofit firm as postulated by Steinberg (1986) are that they either seek to maximise gross resources (revenues), which he refers to as budget maximisers, or maximise the residual available for charitable service. The latter can be done by minimising fundraising and administrative expenses and leaving enough for spending on programme-related charitable activities. He refers to this group as service maximisers. A budget-maximising firm will keep increasing its fundraising expenditure as long as the marginal donative product ($\Delta C/\Delta F$) remains a positive number⁸². A service-maximising firm will only increase fundraising costs when the marginal donative product is at least 1 i.e. as a minimum the marginal returns are equal to the marginal increase in the fundraising costs. Hence there is a likelihood that a budget-maximising charity may pursue wasteful spending. Weisbrod and Dominguez (1986) study the US data using Form 990 of tax returns (1973–1976) and estimate the fundraising elasticity of donations for a sample of nonprofits is not significantly different from zero in all seven industry segments considered. They conclude that '*nonprofit firms are not maximisers of net expenditures on output*' (service maximisers); However, '*they may be maximisers of total expenditures*' (budget maximisers). In contrast, Posnett and

⁸² C is a function of F; where F indicates the fundraising costs and C refers to the associated increase in contribution as a result.

Sandler (1989) find that their sample of UK charities maximises the surplus available for expenditure on charitable output, making them service maximisers.

An organisation is seen as less efficient if a higher portion of its funds are utilised in expenses other than its charitable activities.⁸³ The charities that spend a larger proportion of their funds on furthering their missions and a smaller proportion on administrative or fundraising activities are viewed favourably by their donors. There are various commonly used metrics to assess efficiency in the use of resources received from funders e.g. programme ratio is computed by dividing programme expenses by total expenses; the fundraising ratio is calculated as fundraising expenses divided by total expenses (or total revenues); sometimes administrative costs are also added to fundraising costs, as less expenses and then divided by total expenses. Sometimes the same is expressed as price, where total expenses are divided by charitable activities expenses, with donors expecting a number not much higher than 1. In the UK, as fundraising more commonly feature on media reports in a bad light, I focus on charity's pursuit for low fundraising costs, which congruently also imply high charitable costs. This is not much different in essence to the other metrics discussed above such as quest for higher programme ratio or low price to the donors.

There has been much interest in relative efficiency of fundraising costs (Sargeant and Kähler, 1999) but it is also well established that managers, donors, regulators and reporters care about fundraising cost ratios which can lead to harmful side effects in reporting (Steinburg and Morris, 2010).

The uncertainties about the quality of select few nonprofit organisations might lead the public and media to attribute the same characteristics to all nonprofits. In response, to legitimise itself, a nonprofit is incentivised to signal its trustworthiness to stakeholders (Tremblay-Boire et al. 2016) through various means. It could even be that a smaller number of less ethical charities compel more ethical charities to misreport their programme spending to remain legitimate in the eyes of donors and media. Ratio management is one such way to legitimise their existence. A natural behavioural response to a "legitimate" reference point may be the emulation of the pre-existing behaviour and commonly considered ratios. It is imperative that financial reporting by

⁸³ The charitable activities costs are used for fulfilling the direct objective of a charity and are extensively referred to as programme costs. Both terms have been used interchangeably in this paper.

charities is improved significantly as its misreporting leads to loss of trust, eventually resulting in reduced funding by individuals and institutions (Steinberg, 2006).

A nonprofit is constrained by lack of funds and would therefore do all that is in its control to sustain its funding including misclassification of expenses i.e. moving out a portion of fundraising expenses and transfer into the charitable activities expense category, with the aim to legitimate the levels of programme ratio and fundraising ratio.

Managers are known to use judgement in financial reports to mislead some stakeholders about the underlying performance in for-profit firms (e.g. Healy and Wahlen 1999). Within the earnings management studies in commercial organisations there is a growing body of literature on classification shifting (e.g. McVay, 2006; Fan et al., 2010; Abernathy et al., 2014). Classification shifting does not violate GAAP; hence not scrutinised as stringently by regulators and auditors as accrual-based and real-activities earnings management (McVay, 2006; Fan et al., 2010). The case with nonprofits would however be different where misclassification of expenses has a much larger impact on funders and beneficiaries than in the case of classification shifting in for-profit firms.

McVay (2006) in her seminal study of 76,901 firm-year observations (1988-2003) of US corporations examines the classification of items within the income statement as an earnings management tool. Using a model of core earnings, similar to that of the accrual model between core expenses (cost of goods sold and selling, general, and administrative expenses) and special items, she finds this expense shifting to be more pervasive when incentives to meet the analyst forecast are present, as special items tend to be excluded from this earnings benchmark. Fan et al. (2010), extend McVay's expectation model for core earnings by removing current quarter's accruals and including additional controls for performance. In their study of 67,980 US firms' quarters (1988-2007) they show that classification shifting is more likely in the fourth quarter and when managers are constrained in doing accruals-management (AEM). Abernathy et al. (2014) in their study of 33,619 firm-year observations (1988-2011) find that constraints of both real activities earning management (REM) and AEM lead to higher levels of classification shifting⁸⁴.

⁸⁴ I do not expect a substitution effect in charities between expense misclassification and accruals-management, because both have different objectives. The purpose of misclassification of expenses being a show of the efficiency

Motivations for financial misreporting exist both in for-profit and nonprofit firms, albeit with mostly dissimilar purposes. In the for-profit firms, the incentives for accounting misinformation have been mostly explained through agency theory, focusing at personal gains for the agents (managers), causing moral hazard problems at the cost of principals' (shareholders') desired objectives.

In nonprofit firms, there are few studies which point to agents' personal gains (e.g. Baber et al., 2002; Jegers, 2010) providing evidence of a positive association between managers' compensation and programme spending (Baber et al., 2002), therefore pointing to incentives for an improved programme ratio. Specifically, when the programme spending ratio is higher than the median ratio (in a firm's particular industry), there is a stronger positive relationship between the change in compensation and change in revenue.

Amongst an overall limited amount of accounting literature in the nonprofit sector, a substantial portion is dedicated to expense misclassification, which is somewhat similar to classification shifting in commercial organisations. The managers of nonprofits have a variety of motivations to shift expenses from fundraising expenses into the charitable activities expense category. As nonprofits' managers do not distribute profits as dividends, they can use charitable resources to reward themselves through inflated salaries and perks (e.g. Oster 1995; Baber, et al. 2001; Krishnan et al., 2006). Furthermore, there are institutional pressures to efficiently fulfil the charitable mission (e.g. Meyer and Rowan, 1977; Covalleski et al., 2003), given these pressures nonprofits have been found to shift costs into the programme expense (e.g. Baber et al., 2001; Khumawala et al. 2005; Krishnan et al., 2006; Keating et al., 2008; Krishnan and Yetman, 2011; Parsons et al., 2017) in order to sustain or increase income.

In their study of the US-based nonprofits' data of 1,239 firm years (1992-1998), Baber et al. 2001 suggest that the charities that deviate from their expected programme spending ratio need to be investigated in detail before drawing definitive conclusions

and effectiveness of charity's operations and that it is spending responsibly in fulfilling its charitable objectives, whereas, accruals-management is focused on exhibiting that the charity is not hoarding cash.

about their performance. They find that the unusually high amount of programme spending may be due to large allocations of joint costs to programme spending.

Baber et al. (2002) in their study of 658 US-based charities (years 1996 and 1997) find that changes in compensation are positively associated with changes in spending on programme expenses.

In an experimental design, involving 125 participants, Khumawala et al. (2005) find that preparers base contribution decisions almost entirely on the reported fundraising cost and accept the validity of reported programme ratios. Foundation executives, the experienced user group in the sample, would also accept joint cost allocations as reported, whereas, novice users consider expense allocation disclosures more often when deciding on the amount of a hypothetical gift.

Keating et al. (2008) in their study of a final sample of 16,977 fundraising campaigns, indicate that 74 percent of nonprofit organisations fail to properly report telemarketing expenses. Smaller nonprofits that are less monitored, and those with less accounting sophistication are more likely to misreport costs as a component of net revenues rather than as expense.

Krishnan and Yetman, (2011) study a sample of 620 hospital-year observations of California nonprofit hospitals. They report the hospitals that obtain higher donations revenue, shift costs to a greater extent. Parsons et al., 2017 in their survey of 200 nonprofit executives, investigate the pressures for managing efficiency ratios. They find the donors that make restricted gifts or government grantors influence perceptions of pressure; and more sophisticated managers perceive less pressure to manage ratios. Likewise, monitors and sophisticated managers reduce the likelihood of ratio management.

The prior literature discussed above informs that the nonprofit organisations depending on donations are more likely to manage ratios to report maximum programme spending (e.g. Jones & Roberts, 2006; Krishnan et al., 2006; Keating et al., 2008). Whilst some donors expect, unrealistically low fundraising costs, others are rightfully concerned because there are charities that spend excessive amounts on activities other than those directly associated with the intended charitable causes. This leads managers' focus of attention to various acceptable levels of efficiency ratios

(Krishnan et al., 2006; Tinkelman and Mankaney 2007; Yetman and Yetman 2012), hence increasing the risk of manipulation through expense misclassification. The reporting efficiency of charities is calculated in various ways e.g. by taking the ratio of administration (includes support and governance costs), fundraising and charitable expenses with total costs or income (e.g. Gordon et al., 2006, 2009; Krishnan et al. 2006; Connolly et al., 2013).

In light of the above, I expect that charitable organisations would be motivated to misclassify a portion of their fundraising costs as charitable activities expenses. The propensity of such motivation is expected to be a function of the charity type and predominant funding source. Thus, I posit that a negative relationship will be observed between the unexpected levels of fundraising and charitable activities related costs and, therefore, formulate my first hypothesis as follows:

H1: The unexpected levels of fundraising costs are negatively associated with the unexpected levels of charitable activities costs.

A negative relationship between the two expenses as hypothesised in H1 above, should guide in formulating further testable hypotheses. It is in a similar vein to the initial hypothesis for a negative association between discretionary accruals and pre-managed performance (e.g. Leone and Van Horne, 2005; Verbruggen and Christiaens 2012), which leads to other testable sub-hypotheses.

The donations that a charity may use for any charitable purpose according to its objects⁸⁵ are referred to as unrestricted income. Restricted income can only be used for the purposes that are narrower than the overall charitable purposes of the charity. Technically, the restricted funds that include both restricted income funds and endowments are not reserves of a charity due to the restrictions in their use. Donors can place restrictions on their donations in two ways. Firstly by way of restricted income funds that are spent for the furtherance of specific projects from within the charity's broad objects, and secondly, through endowment funds, whereby mostly assets are permitted to be invested or used by the nonprofit, but the charity is obligated not to spend for charitable purposes other than those narrowly specified outcomes⁸⁶.

⁸⁵ A charity's objects are a statement of its purposes which must be exclusively charitable.

⁸⁶ The endowment funds could be permanent or expendable. Permanent endowments have restrictions but of capital nature, where only the income from the capital bequest, e.g. land, building, cash, investments, can be spent

Therefore, any manipulation of the restricted income or endowment funds, if discovered, may have serious reputational or existential consequences. It is therefore expected that such restrictions would deter management from manipulating. The Statement of financial Activities of a charity is required to present both in separate columns. I would therefore test both separately and both imply a degree of donor sophistication

It is implied by the presence of both restricted income funds or endowment funds that the donors are relatively sophisticated and are likely to monitor the use of their financial support than (often smaller) donors who do not place restrictions on their donations. More sophisticated donors have increased incentive and ability to identify low reporting quality and therefore they discount programme ratios when fundraising expenses appear to be understated (Yetman and Yetman, 2013). On the other hand unsophisticated donors are more likely to accept the reported amounts as they appear (Tinkelman, 1998). Hence monitoring donors reduces the likelihood of ratio management, and financial reporting quality is expected to be better in more sophisticated nonprofits (e.g. Krishnan et al., 2006; Keating et al., 2008; Parsons' et al., 2017). This is in line with the for-profit literature that provides evidence that the level of investor sophistication has a positive impact on financial reporting quality (e.g. Tan et al., 2014; Collins et al., 2003; Balsam et al., 2002). In the nonprofit setting, consistent with the prior nonprofit ratio manipulation literature (e.g. Yetman and Yetman, 2013; Balsam and Harris, 2014), I also classify nonprofits' donors as sophisticated if they make their donations with permanent or temporary restrictions. These restrictions impose direct control over the spending of resources (Silverman & Beatty, 2006; Loftin, 1998). Smaller and less sophisticated donors are expected to donate without restrictions, hence they rely on media to report on the reasonableness of nonprofits' ratios (e.g. Balsam and Harris, 2014; Amin and Harris, 2017). Sophisticated donors have access to more information than their less sophisticated counterparts and are expected to be larger with better resources to closely monitor the performance of a charity. Often, they are members of the nonprofit's boards of

for the charitable causes according to donors' stipulated wishes and instructions. The capital bequest is generally invested in various projects and the generated income from the capital e.g. stock returns are used for the preassigned charitable purposes. Hence a permanent endowment cannot be spent as income, but the capital from the endowment is invested to produce income for the charity. Expendable endowment, however, offer more flexibility to the charity trustees in the use of the funds, hence may have a commutatively more managerial discretion.

directors and hence aware of various internal operations and matters arising in the statutory audit, that are discussed by management (Amin and Harris, 2017).

I use restricted income and endowment funds as proxies for sophistication and expect that sophisticated funders are likely to act as deterrents against misclassification of expense and therefore, formulate the following hypotheses incorporating donor sophistication:

H2a: The association between unexpected fundraising and unexpected charitable activities costs is likely to be less negative for the nonprofits that receive a higher amount of restricted income within their respective peer groups.

H2b: The association between unexpected fundraising and unexpected charitable activities costs is likely to be less negative for the nonprofits that receive a higher amount of endowment funds within their respective peer groups.

Balsam and Harris (2014) categorise nonprofits in two broad types, namely service-oriented and charitable. The service-oriented charities are those that receive a significant amount of their revenues from programme service (charitable activities) income. The Charity SORP refers to them as ‘exchange transactions’ that provide contract income⁸⁷. This could be viewed as a type of earned income as opposed to donations and government grants that do not require services in return.

These service-oriented organisations are expected to have a low donor-beneficiary separation, i.e. donors also receive services from the nonprofit. Service-oriented charities could fall within various charity classifications such as professional institutes with its associate or fellow members paying a certain annual subscription to retain their membership titles, universities with alumni gaining benefits from their association with a prestigious alma mater, and museum patrons having exclusive access to exhibitions by enjoying discounts at museum shops and cafes. These are typical examples of the warm glow (Andreoni, 1990) that would partially be because of the sheer joy of serving the cause while acquiring some sort of benefit in return for the contributions. This is an example of “impure altruism.” Any amount paid over and above the price for such

⁸⁷ CHARITIES SORP (FRS 102) (second edition - October 2019) Assets.publishing.service.gov.uk

benefit is likely to be for the donor's satisfaction that they have made a difference for a relevant cause (Balsam and Harris, 2014).

Charitable organisations, on the other hand, are more reliant on support from donations and government grants without an identifiable economic benefit in return. The donor-beneficiary separation is high. Charitable nonprofits are likely to include organisations that provide support without a fee. The Charity SORP refers to them as income from 'non-exchange transactions' that comprise income from gifts⁸⁸. These may include charities supporting the underprivileged by organising food banks, soup kitchens (Balsam and Harris, 2014) and homeless shelters (Amin and Harris, 2017). The donors for such nonprofits are more likely motivated by pure altruism or impure altruism to the extent that they receive personal satisfaction by contributing to the cause. There are no economic gains expected in return. An increase in demand for financial reporting is expected for the charitable nonprofits with a high donor-beneficiary separation because they do not have many other alternative sources to assess the performance of the charity. This is because of a low level of direct involvement by donors. The information, therefore, contained in financial statements becomes more relevant (Gordon and Khumawala, 1999). On the contrary, the ability to appraise the services and efficiency of a service-oriented nonprofit (Balsam and Harris, 2014) is less dependent on financial statements. Therefore, I would expect a nonprofit would be less motivated to manipulate its efficiency ratios if its funders are more service-oriented compared to its peers, as it would not be interested on the ratios as much as on the identifiable services that they receive in return for their financial support. This leads me to my following hypothesis:

H3: The association between unexpected fundraising and unexpected charitable activities costs is likely to be less negative for service-oriented nonprofits compared to charitable nonprofits.

I would expect a stronger negative relationship between charitable activities expenses and fundraising costs in case of those charities that have a stronger motivation to misclassify. The notion of pure altruism or perceived positive personal impact on a

⁸⁸ CHARITIES SORP (FRS 102) (second edition - October 2019) Assets.publishing.service.gov.uk

donor through contributing (warm glow)⁸⁹ would suggest that a donor would prefer all or a larger portion of their contribution for the intended cause (Andreoni, 1990). A high level of fundraising costs represents a diversion of organisational resources away from the programme spending (e.g. Bowman, 2006; Gneezy et al., 2014). I would, therefore, expect those charities which have higher (lower) than normal levels of fundraising (charitable) costs to be more inclined to misclassifying their fundraising (charitable) costs downwards (upwards).

As a charity's efficiency can be calculated in various ways, such as through its fundraising and charitable programmes ratio with total costs or income, the expense misclassification, therefore, should require tests, using various ratios. I postulate that a charity with a high (low) ratio of fundraising (charitable) costs with total expenses or income, is more likely to consider expense misclassification.

This leads me to my fourth hypothesis, which is stated as follows:

H4: The association between unexpected fundraising and unexpected charitable activities costs is likely to be more (less) negative for nonprofits with relatively higher (lower) fundraising (charitable) costs.

The extant literature (e.g. Gneezy et al., 2014) provides evidence that donors avoid charities that dedicate a high percentage of expenses to administrative costs, as it implies that a nonprofit has not been effective in providing the intended services. Therefore, charities use joint costs to manage their efficiency ratios (e.g. Roberts, 2005; Jones and Roberts, 2006). The joint costs include support costs in carrying out the operations that are both directly associated with programme delivery and other administrative tasks including fundraising costs. If the support costs are high, management may be more prone to misclassifying expenses to avoid unfavourable press attention. Management is known to use its discretion in allocating these support costs e.g. by over-apportioning a larger part of the mailings expense as charitable and less as fundraising costs.

⁸⁹ According to Andreoni (1990) Warm glow (joy of giving) represents the selfish pleasure gained from "doing good", regardless of the actual impact of giving. A donor may be "impurely altruistic" if he is in part motivated by the joy of giving. Pure or perfect altruists are solely motivated by the desire to provide for a recipient.

I therefore posit that the charities reporting a higher amount of support costs than their respective peer groups are expected to have a higher tendency to misclassify expenses. This leads me to the next hypothesis:

H5: The association between unexpected fundraising and unexpected charitable activities costs is likely to be more negative for nonprofits that report high support costs compared to those that report low support costs.

4.4 Research Design

4.4.1 Sample selection

My initial sample constitutes 113,511 nonprofit firm year observations available on the Charity Commission for England and Wales's register of charities⁹⁰ from 2007 to 2018, which covers the entire available data since the first year of its availability. The charities are required to submit their accounts to the Charity Commission within ten months of their financial year-end. Due to limited data availability, mostly of the small charities, the sample consists of all firms with the gross income over £0.5m from 2007 to 2018. After removing charities with less than three years of data and firm years with missing variables, the final sample includes 100,583 firm year observations. I also restrict the sample selection to include only charities that have crossed the audit threshold. Until 2015, the audit threshold for registered charities was £1m, which was subsequently reduced to £0.5m under the Charity Commission's Statement of Recommended Practice (SORP: FRS102).⁹¹

I winsorise all variables used in regressions to minimise the impact of possibly spurious outliers. This is especially important given that the data are skewed towards a large number of small charities.

Given that the selection criteria for the data is to include all those charities that have crossed the audit threshold of £0.5 million in income, there should not have been any firm years in my data below the threshold.

⁹⁰ The content is publicly available under the Open Government Licence v3.0.

⁹¹ In England and Wales, an audit is required if either the charity's gross income exceeds £500,000 or its gross assets exceed £3.26m and gross income exceeds £250,000.
http://www.charitysorp.org/media/619101/frs102_complete.pdf

All charities with a minimum of three years of data are included in the final regressions where standard errors are clustered by firm (Petersen 2009). To mitigate the scale effect, all variables other than expense ratios are deflated by lagged total assets.

4.4.2 Descriptive statistics

Panel A of Table 4.1 provides the descriptive statistics for the main variables in my study. All variables are scaled by lagged total assets, unless otherwise stated. The mean (median) of total income in my sample is 4.91 million (1.55 million) and for total expenses it is 4.71 million (1.50 million). Of the expenses, total fundraising (FR) expenses have the mean (median) of 0.26 million (0 million) and 3.91 million (1.24 million) of charitable activities expenses (CAE). The appendix defines the variables used in the study. My primary variables of interest in the study are unexpected FR (UE_FR) and unexpected CAE (UE_CAE). As expected, since these are the residuals from the estimation regressions, they both have a mean of zero. Panel B presents the correlation matrix which evaluates the linear relationship between the variables used in the analysis. The highest correlation is 0.973 between total expenses and charitable expenses. There does not appear to be issues of multicollinearity between variables used in the regressions, discussed in the next section.

Table 4.1: Descriptive Statistics and Correlation Matrix**Panel A: Descriptive Statistics**

Variable	Obs.	Mean	Median	Std. Dev.	25%	75%
$INCOME_t$ (in millions)	100,853	4.91	1.55	10.22	0.84	4.03
$EXPENSE_t$ (in millions)	100,853	4.71	1.50	10.00	0.80	3.85
FR_t (in millions)	100,853	0.26	0.00	0.83	0.00	0.12
CAE_t (in millions)	100,853	4.27	1.35	9.11	0.70	3.48
ATO_t	84,986	-0.56	0.79	41.24	0.10	2.93
ACC_t	85,050	-0.03	-0.02	0.20	-0.07	0.02
$\Delta INCOME_t$	85,061	0.07	0.03	0.32	-0.06	0.13
NEG_SALES_t	85,061	0.39	0.00	0.49	0.00	1.00
VOL_INC_t	85,050	0.54	0.06	1.45	0.00	0.38
LEG_INC_t	85,050	0.02	0.00	0.06	0.00	0.00
FRI_INC_t	85,050	0.66	0.13	1.55	0.01	0.57
INV_INC_t	85,050	0.01	0.00	0.02	0.00	0.01
OTH_INC_t	85,050	0.02	0.00	0.08	0.00	0.00
$LOG(ASSETS_t)$	100,837	14.81	14.66	1.70	13.52	15.98
ROA_t	100,867	-0.02	0.02	0.52	-0.03	0.11
$SUPPORT_COST_t$	100,853	0.17	0.11	0.21	0.03	0.22
FR_RATIO_t	100,853	0.07	0.00	0.15	0.00	0.06
PR_RATIO_t	100,853	0.89	0.97	0.18	0.89	0.99
FRE_RATIO_t	90,819	6.22	0.01	379.35	0.00	0.28
$UE_FR_t - McVay$	72,090	0.00	-0.01	0.12	-0.02	0.00
$UE_CAE_t - McVay$	72,090	0.00	-0.01	0.60	-0.11	0.10
$UE_FR_t - Yetman$	72,131	0.00	-0.01	0.13	-0.02	0.001
$UE_CAE_t - Yetman$	72,131	0.00	-0.03	0.65	-0.12	0.06
$UE_FR_t - Combined$	60,752	0.00	-0.01	0.11	-0.02	0.01
$UE_CAE_t - Combined$	60,752	0.00	-0.01	0.55	-0.11	0.10

Panel B: Spearman (Below) /Pearson (Above) Correlation Matrix

Variable	$INCOME_t$	$EXPENSES_t$	FR_t	CAE_t	ATO_t	ACC_t	$\Delta INCOME_t$	$NEG_ \Delta INCOME_t$	VOL_INC_t	LEG_INC_t	FRI_INC_t	INV_INC_t	OTH_INC_t	$LOG(ASSETS_t)$	ROA_t	$SUPPORT_COST_t$	FR_RATIO_t	PR_RATIO_t	FRE_RATIO_t
$INCOME_t$	1	0.949	0.488	0.936	0.010	0.006	0.073	-0.080	-0.023	0.120	-0.027	-0.004	0.011	0.529	0.032	-0.079	-0.033	0.020	0.007
$EXPENSES_t$	0.932	1	0.484	0.988	0.007	-0.004	0.017	-0.053	-0.021	0.080	-0.027	-0.001	-0.002	0.515	-0.050	-0.093	-0.043	-0.033	0.009
FR_t	0.263	0.263	1	0.392	0.013	0.000	0.014	-0.023	-0.004	0.169	0.034	0.014	0.020	0.289	0.006	-0.045	0.427	-0.402	0.035
CAE_t	0.897	0.965	0.136	1	0.006	-0.005	0.015	-0.054	-0.019	0.070	-0.031	-0.009	-0.005	0.509	-0.055	-0.092	-0.087	0.096	-0.002
ATO_t	0.038	0.012	0.024	0.017	1	0.004	-0.002	-0.006	-0.117	0.019	-0.111	0.007	-0.001	0.045	0.111	0.018	0.010	-0.012	-0.001
ACC_t	-0.017	-0.045	-0.018	-0.046	-0.045	1	0.043	-0.021	0.007	0.052	0.002	0.038	0.006	0.035	0.078	-0.013	0.004	-0.015	-0.002
$\Delta INCOME_t$	0.172	0.069	0.024	0.066	0.070	0.053	1	-0.552	0.150	0.164	0.156	0.053	0.105	0.027	0.138	-0.025	0.014	-0.014	-0.001
$NEG_ \Delta INCOME_t$	-0.165	-0.095	-0.017	-0.094	-0.061	-0.027	-0.846	1	-0.044	-0.062	-0.051	-0.002	-0.041	-0.034	-0.112	0.004	0.010	-0.019	-0.002
VOL_INC_t	-0.108	-0.135	0.099	-0.135	0.097	0.030	0.109	-0.021	1	0.110	0.957	-0.061	0.043	-0.338	-0.357	-0.066	0.020	0.009	-0.006
LEG_INC_t	0.213	0.151	0.201	0.132	0.027	0.050	0.038	0.000	0.203	1	0.113	0.037	-0.008	0.028	0.139	-0.031	0.102	-0.080	-0.005
FRI_INC_t	-0.099	-0.133	0.194	-0.168	0.137	0.008	0.115	-0.031	0.852	0.151	1	-0.073	0.048	-0.364	-0.325	-0.060	0.091	-0.056	-0.007
INV_INC_t	0.107	0.103	0.104	0.085	-0.104	0.090	0.007	0.005	-0.062	0.229	-0.116	1	-0.033	0.237	0.022	-0.077	-0.003	-0.112	-0.001
OTH_INC_t	0.113	0.098	0.081	0.092	0.024	-0.004	0.034	-0.028	-0.064	0.046	-0.067	0.003	1	-0.104	0.022	0.018	0.048	-0.039	0.041
$LOG(ASSETS_t)$	0.678	0.635	0.197	0.600	-0.212	0.033	0.012	-0.035	-0.344	0.225	-0.398	0.303	0.082	1	0.158	-0.093	-0.015	-0.049	0.008
ROA_t	0.134	-0.104	0.003	-0.102	0.119	0.113	0.332	-0.266	0.119	0.187	0.146	-0.019	0.044	0.024	1	0.106	0.051	-0.084	-0.002
$SUPPORT_COST_t$	-0.025	-0.065	0.025	-0.062	0.042	-0.037	-0.014	0.002	-0.037	0.007	-0.014	-0.062	0.040	-0.043	0.113	1	0.026	-0.011	-0.003
FR_RATIO_t	0.098	0.090	0.965	-0.046	0.021	-0.009	0.015	0.001	0.135	0.182	0.238	0.088	0.058	0.077	0.018	0.044	1	-0.862	0.011
PR_RATIO_t	0.019	0.053	-0.709	0.198	0.066	-0.035	0.010	-0.034	-0.080	-0.198	-0.170	-0.211	-0.040	-0.127	-0.027	-0.058	-0.761	1	-0.039
FRE_RATIO_t	0.140	0.154	0.916	0.040	0.032	-0.035	-0.005	-0.006	-0.060	0.092	0.030	0.064	0.085	0.099	-0.031	0.046	0.916	-0.644	1

Variable Definitions:

Variable	Definition
$INCOME_t$	Total income in year t, in millions
$EXPENSE_t$	Total expenses in year t, in millions
FR_t	Total fundraising expenses in year t, in millions
CAE_t	Total charitable activities expenses in year t, in millions
ATO_t	Asset Turnover in year t as defined in McVay (2006), deflated by lagged total assets ⁹²
ACC_t	Accruals in the year t, deflated by lagged total assets ⁹³
$\Delta INCOME_t$	Change in total income from year t-1 to year t, deflated by lagged total assets
$NEG_ \Delta INCOME_t$	Dichotomous variable: 1 if $\Delta INCOME$ is below 1, 0 otherwise
VOL_INC_t	Voluntary income in year t deflated by lagged total assets
LEG_INC_t	Legacy income in year t deflated by Lagged total assets
FRI_INC_t	Fundraising income in year t deflated by Lagged total assets
INV_INC_t	Investment income in year t deflated by Lagged total assets
OTH_INC_t	Other income deflated in year t by Lagged total assets
$LOG(ASSETS_t)$	Natural logarithm of total assets in year t
ROA_t	Return (Net Income) on assets in year t
$SUPPORT_COST_t$	Support cost divided by total expenses in year t
FR_RATIO_t	Fundraising ratio: Fundraising expense divided total expenses in year t
PR_RATIO_t	Programme expense ratio: Charitable activities expenses divided by total expenses in year t
FRE_RATIO_t	Fundraising efficiency ratio: Fundraising expense divided fund raising income in year t
UE_FR_t	Unexpected fundraising costs estimated by models (1.1) McVay, (1.3) Yetman or (1.5) Combined
UE_CAE_t	Unexpected charitable activities expenses estimated by models (1.2) McVay, (1.4) Yetman or (1.6) Combined

⁹² Defined as $Sales_t / ((Net\ Operating\ Assets_t + Net\ Operating\ Assets_{t-1}) / 2)$. Net Operating Assets, is equal to the difference between Operating Assets - Operating Liabilities. Operating Assets is calculated as Total Assets less Cash. Operating liabilities is calculated as Total Assets less Total Debt.

⁹³ Defined as change in current assets less change in current liabilities less change in cash and depreciation in t.

4.4.3 Methodology

The primary inspiration for the methodology has been drawn from the for-profit research in classification shifting (e.g. McVay 2006; Fan, Barua, Cready, and Thomas 2010; Fan and Liu, 2017). However, certain modifications are made to accommodate the unique setting of nonprofit organisations. Earlier studies in classification shifting (e.g. McVay 2006; Fan and Liu, 2017) conclude that managers opportunistically shift core expenses to special items to inflate current core earnings, resulting in a positive relation between unexpected core earnings and income-decreasing special items. As discussed in the literature, expenses are expected to be shifted from fundraising into charitable activities expenses. Therefore, including the charitable activities expense as the independent variable would be comparable to McVay (2006), whereby these expenses would impact on the level of unexpected fundraising costs.

My initial model for the first hypothesis is based on that proposed by McVay (2006) who uses core earnings (CE) as the dependent variable, regressing this on special items (SI) as the main independent variable. The situation is, however, different for charities because there are no core earnings, calculated by excluding special items from the bottom-line earnings. The model I propose is different from those in the for-profit classification shifting literature to the extent that both fundraising and charitable activities expenses are operating expenses and hence not akin to special items. Therefore, my primary empirical model builds on the CE estimation model (McVay, 2006) for nonprofits, to study classification shifting between fundraising and charitable expense. Insofar as the direction is concerned, the model is well suited for estimating the expense misclassification in charities. This methodology is useful to the extent that the direction of expense movement on classification shifting is from CE to SI, i.e. from the dependent variable to the independent variable (as in McVay, 2006 and subsequent literature). In the same vein, I study the misclassification of fundraising costs as charitable expenses and use predictor income variables in Yetman and Yetman (2012, 2013) to predict the normal level of fundraising expenses.

Therefore, the first stage estimation regressions used to estimate normal/expected levels of fundraising costs as well as charitable activities expenses, follow the methodology in McVay (2006) and Yetman and Yetman (2012, 2013). Following

Steinberg (1986) and Yetman and Yetman (2012, 2013), I estimate the fundraising expense estimation model by using various income types generated from $t+1$ as independent variables. In the same vein, I also estimate the charitable activities expense estimation model. Following previous literature, I incorporate lagged effects in my model because of informational and response delays. Fundraising and donating occur over a fiscal year, rather than at a point in time. Thus, it is quite reasonable to assume that solicitations occurring late in the year result in donations in the following year. I use a fixed-effect model using one year lags.⁹⁴ Although longer lags are theoretically plausible, I follow previous research and limit it to one year. I also add the lagged fundraising and charitable activities expenses in their respective estimation regressions to mitigate simultaneity problems.⁹⁵

The sample is distributed across 11 industries based on the International Classification of Non-profit Organisations (ICNPO). A minimum of 15 observations per industry-year ensures a sufficiently large sample to estimate normal levels of fundraising and charitable costs (e.g. Fan and Liu, 2017). Organisations in the same sector are likely to have a similar objective therefore, I estimate regressions by subgroup and year to calculate normal/expected levels of fundraising and charitable activities costs. I further develop the methodology by also calculating the unexpected level of charitable activities expense. It is preferable to use unexpected charitable activities expenses over using charitable activities expense because the first hypothesis suggests that charities would shift expenses between fundraising (FR) and charitable activities expenses (CAE) and therefore this expense shifting will cause unexpected levels for both expense types. The movement would be in opposite directions.

⁹⁴ Following Steinberg (1986) the assumption is that a firm-specific intercept is constant across time periods and a time-specific intercept is constant across firms. The firm-specific effects control for the idiosyncratic factors e.g. charity's location, specific donors, goodwill in society, popularity of its specific objectives, accounting practices etc. The time-specific effects control for the stage of the charity's life cycle, tax advantages to donors in specific years, popularity of certain charitable programmes in certain years e.g. relief efforts following a catastrophe such as the Coronavirus outbreak.

⁹⁵ '(independent variable) is included as a lagged variable in order to mitigate simultaneity problems' (Aschhoff and Schmidt, 2008). *'We investigate the effect of lagged (variable) on current performance to avoid potential simultaneity problems'* (Gupta, 2005, p 995). *'It is well known that when endogenous variables are used as regressors, the correlation between those variables and the disturbance term renders the OLS estimates biased and inconsistent. For this reason, lagged rather than contemporaneous strategy variables are specified as instruments in an attempt to alleviate (the problem)'* (Spanos et al., 2004).

I estimate the normal levels of FR and CAE in three ways. I employ (a) an estimation regression containing the variables used to estimate CE by McVay (2006), (b) an estimation model similar to Yetman and Yetman (inspired from prior research e.g. Steinberg's, 1986; Yetman and Yetman 2012), and (c) an estimation model combining variables from (a) and (b) as follows:

(a) McVay (2006) estimation regressions:

$$FR_{it} = \alpha_0 + \beta_1 FR_{it-1} + \beta_2 ATO_{it+1} + \beta_3 ACC_{it-1} + \beta_4 ACC_{it} + \beta_5 \Delta INCOME_{it} + \beta_6 NEG_ \Delta INCOME_{it} + \varepsilon_{it} \quad (4.1.1)$$

$$CAE_{it} = \alpha_0 + \beta_1 CAE_{it-1} + \beta_2 ATO_{it+1} + \beta_3 ACC_{it-1} + \beta_4 ACC_{it} + \beta_5 \Delta INCOME_{it} + \beta_6 NEG_ \Delta INCOME_{it} + \varepsilon_{it} \quad (4.1.2)$$

(b) Yetman and Yetman (2012, 2013) estimation regressions:

$$FR_{it} = \alpha_0 + \beta_1 FR_{it-1} + \beta_2 VOL_ INC_{it+1} + \beta_3 LEG_ INC_{it+1} + \beta_4 FR_ INC_{it+1} + \beta_5 INV_ INC_{it+1} + \beta_6 OTH_ INC_{it+1} + \beta_7 Log(Assets_{it+1}) + \varepsilon_{it} \quad (4.1.3)$$

$$CAE_{it} = \alpha_0 + \beta_1 CAE_{it-1} + \beta_2 VOL_ INC_{it+1} + \beta_3 LEG_ INC_{it+1} + \beta_4 FR_ INC_{it+1} + \beta_5 INV_ INC_{it+1} + \beta_6 OTH_ INC_{it+1} + \beta_7 Log(Assets_{it+1}) + \varepsilon_{it} \quad (4.1.4)$$

(c) Combined estimation regressions:

$$FR_{it} = \alpha_0 + \beta_1 FR_{it-1} + \beta_2 ATO_{it+1} + \beta_3 ACC_{it-1} + \beta_4 ACC_{it} + \beta_5 \Delta INCOME_{it} + \beta_6 NEG_ \Delta INCOME_{it} + \beta_7 VOL_ INC_{it+1} + \beta_8 LEG_ INC_{it+1} + \beta_9 FR_ INC_{it+1} + \beta_{10} INV_ INC_{it+1} + \beta_{11} OTH_ INC_{it+1} + \beta_{12} LOG(ASSETS)_{it+1} + \varepsilon_{it} \quad (4.1.5)$$

$$CAE_{it} = \alpha_0 + \beta_1 CAE_{it-1} + \beta_2 ATO_{it+1} + \beta_3 ACC_{it-1} + \beta_4 ACC_{it} + \beta_5 \Delta INCOME_{it} + \beta_6 NEG_ \Delta INCOME_{it} + \beta_7 VOL_ INC_{it+1} + \beta_8 LEG_ INC_{it+1} + \beta_9 FR_ INC_{it+1} + \beta_{10} INV_ INC_{it+1} + \beta_{11} OTH_ INC_{it+1} + \beta_{12} LOG(ASSETS)_{it+1} + \varepsilon_{it} \quad (4.1.6)$$

All variables have been defined in the appendix. The above models are referred to in the remainder of the paper as the McVay model, the Yetman model, and the combined model.

4.4.3.1 Empirical model to test H1

My first research hypothesis is that the unexpected levels of FR and CAE (residuals from the above regressions 1.1 to 1.6) will have a negative relationship. The independent variable CAE is defined as the total *charitable activities costs and grants*

to institutions as contained in the Charity Commission data. Likewise, FR costs are defined as the total *voluntary income cost, fundraising trading costs and other resources expended*. As in prior studies, I use the log of total assets to control for charity size and Return on Asset (ROA) as an additional independent variable to control for the FR costs due to ordinary operations (Kothari et al., 2005). I also include support cost as most of that is apportioned between FR and CAE according to some objective or subjective allocation bases by a nonprofit. I do not make a directional prediction of the control variables due to lack of sufficient literature studying abnormal fundraising costs. The second stage model to test H1 is therefore as follows:

$$UE_{FR_{it}} = \alpha_0 + \beta_1 UE_{CAE_{it}} + \beta_2 LOG(ASSETS_{it}) + \beta_3 ROA_{it} + \beta_4 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.2)$$

4.4.3.2 Empirical models to test H2a and H2b

Building on the existing literature (e.g. Yetman and Yetman, 2013; Balsam & Harris, 2014) that donor sophistication influences donor behaviour, my second hypothesis is that donor sophistication will reduce the incident of expense misclassification.

Following Yetman and Yetman (2013) and Balsam and Harris (2014), I use the existence of restricted donations as a proxy for donor sophistication. The restricted donations are gifts with either permanent or temporary limitations concerning the timing and/or purpose of their use. Similarly, I also use endowment funds as a further proxy for sophistication. To measure donor sophistication vis-à-vis funds restriction I partition my sample nonprofits into those that have above or below median restricted funds using a 1/0 dichotomous variable. To examine the impact of sophistication of donors on the likelihood of expense misclassification, I employ the following model:

$$UE_{FR_{it}} = \alpha_0 + \beta_1 UE_{CAE_{it}} + \beta_2 CHARITYTYPE_{it} + \beta_3 UE_{CAE_{it}} * CHARITYTYPE_{it} + \beta_4 ROA_{it} + \beta_5 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.3)$$

Where *CHARITYTYPE* refers to the sophisticated donor variable (restricted) as described above. All other variables are defined in the appendix. In model (3), I expect the sign of the coefficient on the interaction term (β_3) will be positive hence showing a reduction in the negative relationship between *UE_FR* and *UE_CAE*.

To separate endowment charities from others, I also partition sample nonprofits into those that have above or below the median of endowment funds using a 1/0 dichotomous variable. I use the same model (3) including the sophisticated donor

variable (endowment) as described above. In model (3), I expect the sign of the coefficient on the interaction term (β_3) to be positive hence showing a reduction in the negative relationship between *UE_FR* and *UE_CAE*. The above models are analysed using *UE_FR* and *UE_CAE* from all three estimation approaches.

4.4.3.3 Empirical models to test H3

In nonprofits that are more service-oriented in nature, where the donor-beneficiary separation is either low or absent, it is expected that the propensity and possibility of accounting manipulation will be lower than in less service-oriented charities. This is because a more service-oriented charity donor is likely to have the opportunity to directly evaluate the financial reporting quality of the services. Therefore, it is less likely that these donors will depend entirely on the reported numbers, implying lower motivation for misreporting expenses by such charities' managers. I do not expect that the motivation for such misclassification can be completely absent but its propensity is expected to be lower than for those charities, which are donated predominantly by donors who do not receive services in return.

Following Yetman and Yetman (2013) and Balsam and Harris (2014), I use the level of programme service revenue (PSR)⁹⁶ to proxy for donor sophistication. I calculate PSR by dividing charitable activities income by the total income in the period *t*. PSR is a proxy for services in exchange for donations, hence implying a low donor-beneficiary separation. I partition sample nonprofits into those that have above or below median PSR using a 1/0 dichotomous variable. Specifically, the nonprofit years with lower than the median level of PSR in their respective industry and year group take the value of 1, and 0 otherwise. To examine the relative expense misclassification behaviour by more service-oriented charities, I employ the model in (3), Where *CHARITYTYPE* refers to the service-type variable described above using the partitioning of PSR. In model (3), I expect the sign of the coefficient on the interaction term (β_3) will be positive hence showing a reduction in the negative relationship between *UE_FR* and *UE_CAE*.

⁹⁶ Charitable activities income in the Charity Commission data.

4.4.3.4 Empirical model to test H4

In order to test the fourth hypothesis, I create three expense ratios and test whether they are important considerations for manipulation. To the best of my knowledge, previous studies do not study whether ‘less acceptable’ ratios could be a trigger for expense misclassification.

I define a charity as LOW_PR that has lower than the median level of programme ratio in t-1. Following earlier literature, I calculate this by taking a ratio of charitable activities expense to total expenses. CAE includes charitable activities cost and grants to institutions. I partition sample nonprofits into those that have above or below median programme ratio using a 0/1 dichotomous variable.

The current literature defines FR efficiency ratio by dividing FR expenses by fundraising income. I categorise a firm-year as HIGH_FRE if its FR efficiency ratio in t-1 is above the median of other charities in its industry. The fundraising income relates to donations and FR expense includes *voluntary expenses*, *fundraising trading cost* and *other resources expended*. These are normally the costs that are not directly spent for fulfilling the main charitable causes, hence theoretically “less desirable” for donors. I partition sample nonprofits into those above or below median FR efficiency ratio in t-1 using a 0/1 dichotomous variable.

Following earlier literature, the FR ratio is calculated as FR (fundraising expenses) divided by total expenses. I categorise a firm-year as HIGH_FR if the ratio in t-1 is above the median. The nonprofit years in my sample with higher than the median level of FR ratio in their respective industry and year group take the value of 1 and 0 otherwise HIGH_FR equals 0.

In order to reject the null hypothesis that expense ratios do not affect the expense manipulation behaviour, I employ the following model.

$$UE_{FR_{it}} = \alpha_0 + \beta_1 UE_{CAE_{it}} + \beta_2 RATIO_SUSPECT_{it} + \beta_3 UE_{CAE_{it}} * RATIO_SUSPECT_{it} + \beta_4 LOG(ASSETS_{it}) + \beta_5 ROA_{it} + \beta_6 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.4)$$

RATIO_SUSPECT in the above regression represents either LOW_PR, HIGH_FRE or HIGH_FR. All other variables are defined in the appendix. The expected sign of the coefficient on the $UE_{CAE_{it}} * RATIO_SUSPECT_{it}$ interaction term is negative.

4.4.3.5 Empirical model to test H5

Lastly, to test my fifth hypothesis, I define a nonprofit year as HIGH_SC if it has higher than the median level of support costs in year t. I partition sample nonprofits into those that have above or below median support cost using a 0/1 dichotomous variable. In order to reject the null hypothesis that high support cost is not a factor to affect manipulation behaviour, I employ the following model.

$$UE_{FR_{it}} = \alpha_0 + \beta_1 UE_{CAE_{it}} + \beta_2 HIGH_{SC_{it}} + \beta_3 UE_{CAE_{it}} \times HIGH_{SC_{it}} + \beta_4 LOG(ASSETS_{it}) + \beta_5 ROA_{it} + \beta_6 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.5)$$

All variables are defined in the appendix. The expected sign of the coefficient on the interaction variable, $UE_{CAE_{it}} * HIGH_{SC_{it}}$ is negative.

4.5 Results

4.5.1 Estimation using McVay model

Table 4.2 presents the mean and median coefficients and p-values from running 319 regressions for each of the expenses for the three estimation models (1.1 to 1.6).⁹⁷

Panel A presents the results using the McVay model. The first variable is lagged for the respective FR and CAE expense estimation regressions. The coefficient shows persistence of the expenses from year t-1 to year t (Median coefficient 0.774 between FR_t and FR_{t-1} and 0.993 between CAE_t and CAE_{t-1}).

I expect the remaining variables to have opposite signs to those shown in McVay (2006) as I model for expenses as opposed to her estimation of core earnings. Since the asset turnover ratio (ATO) is inversely related to profit margin (e.g., Nissim and Penman 2001; MvVay 2006), therefore its relationship with FR and CAE is expected to be positive.

In prior literature, accruals have been reported as highly correlated with extreme performance changes (DeAngelo et al. 1994); unexpectedly good (poor) performance

⁹⁷ For estimating normal levels of each of the two expenses and 11 charity subgroups, totalling 638 estimation regressions, I run 110 regressions following Yetman and Yetman, 2013 (2008-2017), 110 following McVay, 2006 (2009-2018) and 99 for the combined model (2009-2017).

is positively associated with a large increase (decrease) in accruals. Following McVay (2006), I also include accruals in year t and $t-1$. Erratic income movements may be conceivable, but I would not expect frequently large changes in expenses. I do not have a directional prediction for accruals.

For charities, the link between income and expense is not necessarily always in the same direction. For example, charities that spend a large amount to prepare for a fundraising event in advance of a flagship event, such as a charity gala, will face a period mismatch in reporting its expense and income (Essay 1). However, overall, I would expect expenses to be in line with income and a negative change in sales to have a negative association with FR and CAE. Legacy income is an efficient way to sustain future income for a nonprofit. It is, however, difficult to predict but needs to be ensured through employing significant fundraising costs in convincing the public to leave their bequest for the nonprofit. I expect a negative relationship between CAE and legacy income, the reason being that resources would need to be diverted away from providing information and paying administrative costs for the fundraising team in convincing potential donors to leave funds to the organisation through their will. I would expect voluntary and fundraising income to benefit from a higher amount of spending on CAE as theory suggest their positive impact on donors' willingness to donate as they perceive that the charity is spending for the charitable causes. I do not have a sign prediction for other income.

In panel A, as expected the relationship for FR and CAE is positive and significant with their lagged counterparts (mean coefficient = 0.675 and mean p-value = 0.007 for FR; mean coefficient = 0.986 and mean p-value = 0.000 for CAE). The coefficient on ATO does not appear to be significantly different from zero for both expense categories. $Accruals_{t-1}$ is also not significantly different from zero for both expense categories. For charities, income and expenses may be accrued between years, due to legacy and deferred donations and grants. The direction of the coefficient is as expected i.e. positive (as for core earnings it is expected negative) but the results are not significant for both FR and CAE. $Accruals_t$ are significant and negative as expected for CAE (coefficient= -0.229, p-value=0.086). For core earnings as per McVay (2006) the predicted and observed sign is positive, hence a negative relationship is expected with expenses. Examples could include amounts that are not yet paid to the beneficiaries such as grant commitments from a foundation charity to a smaller charity. While the

mean for the $Accruals_t$ coefficient is not significant in predicting FR_t , the results are weakly significant using the median of the industry-year estimation regressions (coefficient= -0.01, p-value=0.099). An insignificant mean of the coefficient on $Accruals_t$ may be partially because of a low amount of fundraising costs in the accounts, of which accrued expenses may be a very small fraction.

I substitute the term Sales in McVay (2006) for Income as charities' income is largely from non-trading activities and hence the term sales may not represent the predominant reality for charities. The expenses are expected to move in the same direction as Income. Panel B of Table 4.2 shows that as expected the direction is positive for both expenses but the mean and median are not significant for FR. CAE is significantly positive (coefficient= 0.536, p-value=0.009). The expected and observed coefficient signs are negative for $NEG_ΔINCOME$ from time t-1 to t. The median p-value for CAE estimation is significant (coefficient = -0.064, median p-value=0.045). Various individual industry year results are significant for both FR and CAE but only averages are tabulated in Panel A of Table 4.2.

4.5.2 Estimation using Yetman model

Using the theoretical link motivated by Steinberg (1986) and Yetman and Yetman (2012, 2013), I expect the coefficient signs on various income types would depend on how the donors view the reporting quality of fundraising and charitable activities expense. A positive sign for FR expense's predictor income variables would point to a positive impact of fundraising spending in promoting the charitable cause to donors. A negative sign may point to either a negative impact on a section of donors who disapprove of fundraising costs or a switch from one income type e.g. voluntary income to another income type e.g. other income. Likewise, a positive sign for the CAE expense predictor income variables would point to a positive impact on donors indicating their belief that the charity is spending on the right causes. A negative impact may be an indication that a higher amount spent on CAE may either be viewed as expense classification shifting or an indication that low investment in promotional or other similar non-programme expenses in the prior period affects donations in the following year.

In light of the theory, I expect that the voluntary donations will be negatively associated with fundraising costs. This is one of the fundamental assumptions in this line of literature. On the contrary, I would expect a positive relationship between fundraising

income and FR expense. This is because charities need to invest in certain fundraising events and as a result, they generate income. As discussed earlier, it is correct to assume that future income depends on current fundraising expenses to generate that income. I expect investment income to be negatively associated with fundraising expense because such spending would not help this type of income as it would take the resources away from investment-related costs.

Panel B of Table 4.2 presents the results using the Yetman and Yetman (2012, 2013) variables. The lagged variables to predict FR and CAE are both significantly positive. VOL_INC_{t+1} is weakly insignificant and negatively (positively) associated with FR (CAE). A negative relationship (coefficient -0.022, p-value=0.119) with FR alludes to a general dislike by the donors for FR expenses. The insignificant result perhaps explains that there are also benefits of fundraising costs for future voluntary donations. A positive relationship (mean coefficient 0.014, mean p-value=0.115, median coefficient 0.000, median p-value=0.028) with CAE points to the established knowledge of donors' affinity towards higher levels of CAE but the result is too weak to give confidence that it confirms the theory.

The coefficient on LEG_INC_{t+1} is not significant for both expenses of interest, suggesting that legacy income is not conclusively affected by the levels of fundraising and charitable activities. There are various competing forces and it is likely that their net effect becomes insignificant. For example fundraising activities help in increasing the legacy income but donors who plan to leave a sizeable portion of their lifelong savings are less keen on funding a charity that spends a higher than acceptable level on fundraising activities. The amount spent on CAE may have a positive impact on donors leaving their bequest but there may be insufficient allocation for fundraising activities, hence they are less informed on how a charity fulfils their individual aims and objectives for their legacy funds, and overall the balance shifts towards a negative but statistically insignificant impact.

FRI_INC_{t+1} has a significantly positive relationship with FR (mean coefficient 0.042, mean p-value=0.053) points to the logical explanation that a charity's fundraising income is positively associated with the expense on fundraising activities. An example is a fundraising event, costs of which are paid from the fundraising expense category. Its relationship with FR being opposite to that for Voluntary Income is understandable.

Likewise, a significantly positive relationship with CAE (mean coefficient 0.089, mean p-value=0.077) points to the established knowledge of donors' preference for higher levels of CAE, leading to higher fundraising income in subsequent period(s), it is also consistent with the theory. The relationship with INV_INC_{t+1} and OTH_INC_{t+1} is not significant for both FR and CAE. This is understandable due to the nature of these income types. I would expect that investment income does not have a direct link with either fundraising or charitable activities expense in the previous period, only to the extent that there may be less resources available to making investments, but that may not be a strong argument against this observation.

$LOG(ASSETS_{t+1})$ has a positive and significant association with CAE expense (mean coefficient 2,928.5, mean p-value=0.096). It would be plausible to expect a positive relationship between CAE, the largest expense type and assets. It is conceivable that a larger charity will be spending a larger sum on its charitable activities.

4.5.3 Estimation using the combined model

Panel C of Table 4.2 presents the results using the combined estimation models for the two expenses of interest. FR_{t-1} and CAE_{t-1} have a significantly positive relationship with FR_t and CAE_t respectively. The coefficient on ATO does not appear to be significantly different from zero for both expense categories. Accruals in year t-1 is also not significantly different from zero for both expense categories. The direction of the coefficient is positive as expected. Accruals in year t is significant and negative as expected for CAE (mean coefficient -0.234, mean p-value=0.095). $\Delta INCOME_t$ as expected, has a positive association with both expense types, albeit not significant with FR expense. The association is significantly positive (mean coefficient= 0.5, p-value=0.014) with CAE. The expected and observed coefficient signs are negative for NEG_INCOME from time t-1 to t. The median p-value for CAE estimation is significant (coefficient = -0.06, median p-value=0.053). Several individual industry year results are significant for both FR and CAE but only averages are tabulated in Panel C of Table 4.2.

VOL_INC_{t+1} is weakly insignificant and negatively (positively) associated with FR (CAE). A negative relationship (mean coefficient -0.022, p-value=0.122) with FR alludes to a general dislike by the donors for FR expenses. The insignificant result perhaps explains that there are also benefits of fundraising costs for future voluntary donations. A positive relationship (mean coefficient 0.02, mean p-value=0.109,

median p-value=0.025) with CAE points to the established knowledge of donors' affinity towards higher levels of CAE.

The coefficient on LEG_INC_{t+1} is not significant for expenses, suggesting that legacy income is not conclusively associated with the levels of fundraising and charitable activities. The weakly insignificant and positive (negative) association with FR (CAE) complements the directional predictions. A negative coefficient (mean coefficient -0.081, p-value=0.188) for FR estimation indicates a general aversion to FR expenses.

FRI_INC_{t+1} has a significantly positive relationship with FR (mean coefficient 0.038, mean p-value=0.065) suggesting that a charity's fundraising income is positively associated with the expense on fundraising activities. As predicted, a significantly positive relationship with CAE (mean coefficient 0.051, mean p-value=0.09) suggests that donors like to observe high levels of CAE. The association with INV_INC_{t+1} and OTH_INC_{t+1} is not significant for both FR and CAE. There is no theoretical reason for investment income to be associated with fundraising or charitable activities expense. Similarly other income is expected to be of miscellaneous and irregular nature, hence less likely to have an association with either expense.

The signs of FR and CAE with $LOG(ASSETS_{t+1})$ are, although not significant. This perhaps points to the substitution effect of the two expense types. It would be plausible to expect a positive relationship between the largest expense type, the CAE, and assets. It is conceivable that a larger charity will be spending a larger sum on its charitable activities and the marginal costs of fundraising due to the fixed costs element (e.g. fundraising staff salaries or other administrative costs) will decrease with the increase in the size of a charity, hence a negative sign is expected in estimating FR.

Table 4.2: Estimation models for normal levels of FR and CAE**Panel A: McVay model**

The table presents results of the regression of the forms:

$$FR_{it} = \alpha_0 + \beta_1 FR_{it-1} + \beta_2 ATO_{it+1} + \beta_3 ACC_{it-1} + \beta_4 ACC_{it} + \beta_5 \Delta INCOME_{it} + \beta_6 NEG_ \Delta INCOME_{it} + \varepsilon_{it} \quad (4.1.1)$$

$$CAE_{it} = \alpha_0 + \beta_1 CAE_{it-1} + \beta_2 ATO_{it+1} + \beta_3 ACC_{it-1} + \beta_4 ACC_{it} + \beta_5 \Delta INCOME_{it} + \beta_6 NEG_ \Delta INCOME_{it} + \varepsilon_{it} \quad (4.1.2)$$

Independent Variable	Prediction	Dependant Variable: FR_t				Dependant Variable: CAE_t			
		Mean		Median		Mean		Median	
		Coeff	P-value	Coeff	P-value	Coeff	P-value	Coeff	P-value
<i>Intercept</i>		0.017	0.171	0.015*	0.080	0.059	0.237	0.054*	0.085
FR_{t-1}	+	0.675***	0.007	0.774***	0.000				
CAE_{t-1}	+					0.986***	0.000	0.993***	0.000
ATO_t	+	0.000	0.196	0.000	0.167	0.000	0.193	0.000	0.158
ACC_{t-1}	+	0.004	0.174	0.006	0.117	0.062	0.172	0.046	0.108
ACC_t	-	-0.018	0.154	-0.010*	0.099	-0.229**	0.086	-0.200**	0.019
$\Delta INCOME_t$	+	0.033	0.158	0.019	0.102	0.536***	0.009	0.448***	0.000
$NEG_ \Delta INCOME_t$	-	-0.003	0.227	-0.001	0.209	-0.070	0.119	-0.064**	0.045
R^2		0.54		0.62		0.92		0.92	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Panel B: Yetman model

The table presents results of the regression of the forms:

$$FR_{it} = \alpha_0 + \beta_1 FR_{it-1} + \beta_2 VOL_INC_{it+1} + \beta_3 LEG_INC_{it+1} + \beta_4 FR_INC_{it+1} + \beta_5 INV_INC_{it+1} + \beta_6 OTH_INC_{it+1} + \beta_7 LOG(ASSETS_{it+1}) + \varepsilon_{it} \quad (4.1.3)$$

$$CAE_{it} = \alpha_0 + \beta_1 CAE_{it-1} + \beta_2 VOL_INC_{it+1} + \beta_3 LEG_INC_{it+1} + \beta_4 FR_INC_{it+1} + \beta_5 INV_INC_{it+1} + \beta_6 OTH_INC_{it+1} + \beta_7 LOG(ASSETS_{it+1}) + \varepsilon_{it} \quad (4.1.4)$$

Independent Variable	Prediction FR/CAE	Dependant Variable: FR_t				Dependant Variable: CAE_t			
		Mean		Median		Mean		Median	
		Coeff	P-value	Coeff	P-value	Coeff	P-value	Coeff	P-value
<i>Intercept</i>		0.012	0.270	0.010	0.144	0.098	0.134	0.083**	0.016
FR_{t-1}	+	0.629***	0.002	0.702***	0.000				
CAE_{t-1}	+					0.895***	0.000	0.922***	0.000
VOL_INC_{t+1}	-/+	-0.022	0.119	-0.004**	0.027	0.014	0.115	0.000**	0.028
LEG_INC_{t+1}	+/-	0.096	0.184	0.076	0.177	-0.346	0.189	-0.359	0.151
FR_INC_{t+1}	+/+	0.042*	0.053	0.020***	0.000	0.089*	0.077	0.093***	0.001
INV_INC_{t+1}	-/-	-0.013	0.233	-0.114	0.217	-1.066	0.179	-0.891	0.137
OTH_INC_{t+1}	?/?	0.050	0.184	0.036	0.144	0.266	0.137	0.235*	0.086
$LOG(ASSETS_{t+1})$?/?	4.451	0.152	-19.77	0.106	2928.5*	0.096	1795.6***	0.007
R^2		0.58		0.66		0.91		0.91	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Panel C: The combined model

The table presents results of the regression of the forms:

$$FR_{it} = \alpha_0 + \beta_1 FR_{it-1} + \beta_2 ATO_{it+1} + \beta_3 ACC_{it-1} + \beta_4 ACC_{it} + \beta_5 \Delta INCOME_{it} + \beta_6 NET_ \Delta INCOME_{it} + \beta_7 VOL_ INC_{it+1} + \beta_8 LEG_ INC_{it+1} + \beta_9 FR_ INC_{it+1} + \beta_{10} INV_ INC_{it+1} + \beta_{11} OTH_ INC_{it+1} + \beta_{12} LOG(ASSETS_{it+1}) + \varepsilon_{it} \quad (4.1.5)$$

$$CAE_{it} = \alpha_0 + \beta_1 CAE_{it-1} + \beta_2 ATO_{it+1} + \beta_3 ACC_{it-1} + \beta_4 ACC_{it} + \beta_5 \Delta INCOME_{it} + \beta_6 NET_ \Delta INCOME_{it} + \beta_7 VOL_ INC_{it+1} + \beta_8 LEG_ INC_{it+1} + \beta_9 FR_ INC_{it+1} + \beta_{10} INV_ INC_{it+1} + \beta_{11} OTH_ INC_{it+1} + \beta_{12} LOG(ASSETS_{it+1}) + \varepsilon_{it} \quad (4.1.6)$$

Independent Variable	Prediction	Dependant Variable: FR_t				Dependant Variable: CAE_t			
		Mean		Median		Mean		Median	
		Coeff	P-value	Coeff	P-value	Coeff	P-value	Coeff	P-value
<i>Intercept</i>		0.012	0.343	0.009	0.253	0.081	0.219	0.069**	0.050
FR_{t-1}	+	0.644***	0.007	0.720***	0.000				
CAE_{t-1}	+					0.910***	0.000	0.937***	0.000
ATO_t	+	0.000	0.192	0.000	0.159	0.000	0.210	0.000	0.188
ACC_{t-1}	+	0.008	0.201	0.000	0.154	0.034	0.174	0.017	0.130
ACC_t	-	-0.010	0.178	-0.008	0.168	-0.234*	0.095	-0.207***	0.008
$\Delta INCOME_t$	+	0.025	0.176	0.018	0.137	0.500**	0.014	0.420***	0.000
$NEG_ \Delta INCOME_t$	-	-0.005	0.235	-0.003	0.215	-0.062	0.120	-0.060*	0.053
$VOL_ INC_{t+1}$	-/+	-0.022	0.122	-0.003**	0.036	0.020	0.109	0.002**	0.025
$LEG_ INC_{t+1}$	+/-	0.081	0.188	0.069	0.166	-0.312	0.165	-0.337	0.158
$FRI_ INC_{t+1}$	+/+	0.038*	0.065	0.020***	0.000	0.051*	0.090	0.040**	0.012
$INV_ INC_{t+1}$	-/-	-0.048	0.243	-0.146	0.248	-1.688	0.160	-1.227	0.135
$OTH_ INC_{t+1}$?/?	0.041	0.196	0.034	0.201	0.176	0.177	0.133	0.154
$LOG(ASSETS_{t+1})$?/?	-49.76	0.173	-48.40*	0.097	2787.5	0.118	1893.6**	0.031
R^2		0.60		0.68		0.93		0.93	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Variable definitions:

Variable	Definition
$INCOME_t$	Total income in year t, in millions
$EXPENSE_t$	Total expenses in year t, in millions
FR_t	Total fundraising expenses in year t, in millions
CAE_t	Total charitable activities expenses in year t, in millions
ATO_t	Asset Turnover in year t as defined in McVay (2006), deflated by lagged total assets ⁹⁸
ACC_t	Accruals in the year t, deflated by lagged total assets ⁹⁹
$\Delta INCOME_t$	Change in total income from year t-1 to year t, deflated by lagged total assets
$NEG_ \Delta INCOME_t$	Dichotomous variable: 1 if $\Delta INCOME$ is below 1, 0 otherwise
VOL_INC_t	Voluntary income in year t deflated by lagged total assets
LEG_INC_t	Legacy income in year t deflated by Lagged total assets
FRI_INC_t	Fundraising income in year t deflated by Lagged total assets
INV_INC_t	Investment income in year t deflated by Lagged total assets
OTH_INC_t	Other income deflated in year t by Lagged total assets
VOL_INC_{t+1}	Voluntary income in year t+1 deflated by lagged total assets
LEG_INC_{t+1}	Legacy income in year t+1 deflated by Lagged total assets
FRI_INC_{t+1}	Fundraising income in year t+1 deflated by Lagged total assets
INV_INC_{t+1}	Investment income in year t+1 deflated by Lagged total assets
OTH_INC_{t+1}	Other income deflated in year t+1 by Lagged total assets
$LOG(ASSETS_t)$	Natural logarithm of total assets in year t
ROA_t	Return (Net Income) on assets in year t
$SUPPORT_COST_t$	Support cost divided by total expenses in year t
UE_FR_t	Unexpected fundraising costs estimated by models (1.1) McVay, (1.3) Yetman or (1.5) Combined
UE_CAE_t	Unexpected charitable activities expenses estimated by models (1.2) McVay, (1.4) Yetman or (1.6) Combined
$Sophisticated_t$	Dummy variable equal to 1 if the charity has above-median restricted funds within its respective nonprofit classification, and 0 otherwise.
$Endowment_t$	Dummy variable equal to 1 if the charity has above-median endowment fund ratio end of year endowment fund divided by total funds) within its respective nonprofit classification, and 0 otherwise.
$Service_t$	Dummy variable equal to 1 if the charity has above-median program service revenue to total revenue within its respective nonprofit classification, and 0 otherwise.

⁹⁸ Defined as $Sales_t / ((Net\ Operating\ Assets_t + Net\ Operating\ Assets_{t-1}) / 2)$. Net Operating Assets, is equal to the difference between Operating Assets - Operating Liabilities. Operating Assets is calculated as Total Assets less Cash. Operating liabilities is calculated as Total Assets less Total Debt.

⁹⁹ Defined as change in current assets less change in current liabilities less change in cash and depreciation in t.

4.5.4 Expense shifting hypothesis (H1)

My first hypothesis is based on the expectation that the relationship between unexpected fundraising expenses and unexpected charitable activities expenses will be negative. This is because in order to show low fundraising costs, charities would be inclined to allocate more expenses to charitable activities than fundraising expenses. A charity that employs expense shifting will have lower than expected fundraising costs. Table 4.3 shows that the relationship between the two major expense categories is significantly negative, indicating expense misclassification. Table 4.3 reports the results of the estimation of fixed-effects models for all three sets of variables using McVay (2006), Yetman and Yetman (2013) and the combined model. As predicted by the expense shifting hypothesis, the coefficient on *UE_CAE* is negative and highly significant employing all three estimation models ($\beta_1 = -0.057$, -0.050 and -0.068 with *UE_FR* as the dependent variable using the McVay model, the Yetman model, and the combined model, respectively). The coefficient on return on assets is significantly negative and the coefficient on size is significantly positive for all three estimation models. This points to the fact that large charities are less prone to manipulation, which could be either because of a large surplus or low amounts of assets that will lead to more manipulative behaviour.

Table 4.3: H1 results**Regressions testing association between UE_FR and UE_CAE****Panel A: Results using McVay model**

The table presents results of the regression of the form:

$$UE_FR_{it} = \alpha_0 + \beta_1 UE_CAE_{it} + \beta_2 LOG(ASSETS_{it}) + \beta_3 ROA_{it} + \beta_4 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.2)$$

Independent Variable	Prediction	Coeff	P-value
<i>Intercept</i>		-0.093***	0.003
<i>UE_CAE_t</i>	-	-0.057***	0.000
<i>LOG(ASSETS_t)</i>	+	0.006***	0.003
<i>ROA_t</i>	-	-0.049***	0.000
<i>SUPPORT_COST_t</i>		-0.012***	0.005
<i>Observations</i>		69,874	
<i>R²</i>		0.04	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Panel B: Results using Yetman model

The table presents results of the regression of the form:

$$UE_FR_{it} = \alpha_0 + \beta_1 UE_CAE_{it} + \beta_2 LOG(ASSETS_{it}) + \beta_3 ROA_{it} + \beta_4 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.2)$$

Independent Variable	Prediction	Coeff	P-value
<i>Intercept</i>		-0.234***	0.000
<i>UE_CAE_t</i>	-	-0.050***	0.000
<i>LOG(ASSETS_t)</i>	+	0.016***	0.000
<i>ROA_t</i>	-	-0.039***	0.000
<i>SUPPORT_COST_t</i>		-0.019***	0.000
<i>Observations</i>		69,922	
<i>R²</i>		0.03	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Panel C: Results using the combined model

The table presents results of the regression of the form:

$$UE_FR_{it} = \alpha_0 + \beta_1 UE_CAE_{it} + \beta_2 LOG(ASSETS_{it}) + \beta_3 ROA_{it} + \beta_4 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.2)$$

Independent Variable	Prediction	Coeff	P-value
<i>Intercept</i>		-0.265***	0.000
<i>UE_CAE_t</i>	-	-0.068***	0.000
<i>LOG(ASSETS_t)</i>	+	0.018***	0.000
<i>ROA_t</i>	-	-0.060***	0.000
<i>SUPPORT_COST_t</i>		-0.011**	0.013
<i>Observations</i>		58,447	
<i>R²</i>		0.04	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Variable definitions:

Variable	Definition
<i>UE_FR_t</i>	Unexpected fundraising costs estimated by models (1.1) McVay, (1.3) Yetman or (1.5) Combined
<i>UE_CAE_t</i>	Unexpected charitable activities expenses estimated by models (1.2) McVay, (1.4) Yetman or (1.6) Combined
<i>LOG(ASSETS_t)</i>	Natural logarithm of total assets in year t
<i>ROA_t</i>	Return (Net Income) on assets in year t
<i>SUPPORT_COST_t</i>	Support cost divided by total expenses in year t

4.5.5 Effect of sophisticated donors (H2)

My second hypothesis is that charities with sophisticated donors will have less expense misclassification, given the donors' better insight of the charity. Table 4.4 shows that sophisticated donors have a negative impact on the propensity for manipulation such that the relationship between UE_FR and UE_CAE is less negative. The sophistication in the sample has been defined in two ways. First, for those donors who place restrictions on donations, and such amounts are shown as restricted funds in the nonprofits' Balance Sheets. The second type of restriction is expected to be even stronger due to the effect of closer monitoring of donors in endowment charities. Both instances of restriction are expected to be deterrents for charities' managers' tendency to misclassify expenses.

As confirmed by the results in Table 4.4, I find that charities that receive a higher level of their funds from donors who gift through restricted donations are less manipulative. Specifically, the coefficient for the interaction effect is significantly different from zero, suggesting that managers of a charity funded largely in the form of restricted donations is less prone to misclassify expenses. For instance, if UE_CAE and UE_FR are calculated using McVay (2006) model, for the nonprofits that are funded more through restricted donations, the total effect of UE_CAE on UE_FR would be -0.044 (main coefficient -0.069 added to the interaction coefficient +0.025). The interaction coefficient is significant in the remaining two models also (coefficient = 0.019, p-value = 0.007 using the Yetman model; coefficient = 0.025, p-value = 0.007 using the combined model).

Charities with high levels of endowment funds also have a higher level of sophistication of donors through close monitoring and restriction on the use of funds. The second set of results in Table 4.4 suggest that the relationship between UE_FR and UE_CAE becomes less negative by interacting UE_CAE with highly endowed charities. The interaction variable is significantly different from zero, suggesting that managers are less prone to misclassifying expenses if a charity is funded primarily through endowment funds.

I find (see Table 4.4) the interaction term for charities with ENDOWMENT type funding (coefficient = 0.040, p-value = 0.000) is significantly positive, using the McVay model. Similarly, the interaction term is significantly positive using the other two models

(coefficient = 0.016, p-value 0.089 using the Yetman model, coefficient = 0.036, p-value = 0.000 using the combined model).

4.5.6 Effect of service-oriented charities (H3)

My third hypothesis is that the charities with higher than the median level of programme revenue in their respective charity subgroup (i.e. more service-oriented) will be less prone to misclassifying between fundraising and charitable activities expenses. This is because the donor-beneficiary distance is generally expected to be lower for more service-oriented charities, hence there are other methods to appraise the performance of a charity than just the reported figures for the donors/beneficiaries. The performance of a charity is better seen by the beneficiaries who in many cases also happen to be its financial supporters. Table 4.4 shows that the interaction effect of more service-oriented charities is negative implying that it reduces the negative relationship between UE_FR and UE_CAE. The sum of the two coefficients is significantly different from zero, suggesting that managers are less prone to misclassifying expenses if a charity falls within the service-oriented category.

Specifically, as shown in the final column of Table 4.4, I find that charities with a higher level of funds from donors who gift through restricted donations are less manipulative. (coefficient of interaction term in the McVay model = 0.020, p-value = 0.004; coefficient = 0.028, p-value = 0.000 using the Yetman model; coefficient = 0.035, p-value = 0.000 using the combined model).

A possible explanation for the negative coefficient on the service-oriented variable could be that such charity is less likely to spend on fundraising costs compared to their charitable nonprofit counterparts, because charitable firm by definition depends more on raising funds from private and public sources and that is not in exchange of services to the donors. Such charities are expected to make more efforts to convince disparate donors; hence in a large industry pool for estimation that includes both service-oriented and charitable nonprofits, It is possible that lower levels of fundraising costs are attributable to the service-oriented nonprofits, hence in a large estimation pool they appear unexpectedly low in fundraising costs, leading to a negative unexpected fundraising and service-oriented charity relationship.

Table 4.4: H2 and H3 results:**Regressions of UE_FR on UE_CAE with charity type interactions****Panel A: Results using McVay model**

The table presents results of the regression of the form:

$$UE_FR_{it} = \alpha_0 + \beta_1 UE_CAE_{it} + \beta_2 CHARITYTYPE_{it} + \beta_3 UE_CAE_{it} * CHARITYTYPE_{it} + \beta_4 ROA_{it} + \beta_5 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.3)$$

Independent Variable	Prediction	Restricted		Endowment		Service	
		Coeff	P-value	Coeff	P-value	Coeff	P-value
<i>Intercept</i>		-0.086***	0.005	-0.094***	0.002	-0.080***	0.009
<i>UE_CAE_t</i>	-	-0.069***	0.000	-0.059***	0.000	-0.065***	0.000
<i>CHARITYTYPE_t</i>	?	-0.001	0.207	0.009**	0.019	-0.021***	0.000
<i>UE_CAE_t</i> <i>* CHARITYTYPE_t</i>	+	0.025***	0.002	0.040***	0.000	0.020***	0.004
<i>LOG(ASSETS_t)</i>	+	0.006***	0.004	0.006***	0.002	0.006***	0.003
<i>ROA_t</i>	-	-0.048***	0.000	-0.049***	0.000	-0.050***	0.000
<i>SUPPORT_COST_t</i>	-	-0.012***	0.004	-0.011***	0.005	-0.012***	0.003
<i>Observations</i>		69,874		69,874		69,874	
<i>R²</i>		0.04		0.04		0.05	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Panel B: Results using Yetman model

The table presents results of the regression of the form:

$$UE_{FR_{it}} = \alpha_0 + \beta_1 UE_{CAE_{it}} + \beta_2 CHARITYTYPE_{it} + \beta_3 UE_{CAE_{it}} * CHARITYTYPE_{it} + \beta_4 ROA_{it} + \beta_5 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.3)$$

Independent Variable	Prediction	Restricted		Endowment		Service	
		Coeff	P-value	Coeff	P-value	Coeff	P-value
<i>Intercept</i>		-0.231***	0.000	-0.231***	0.000	-0.226***	0.000
<i>UE_CAE_t</i>	-	-0.060***	0.000	-0.051***	0.000	-0.063***	0.000
<i>CHARITYTYPE_t</i>	?	0.003*	0.080	0.011***	0.007	-0.027***	0.000
<i>UE_CAE_t</i> <i>* CHARITYTYPE_t</i>	+	0.019***	0.007	0.016*	0.089	0.027***	0.000
<i>LOG(ASSETS_t)</i>	+	0.015***	0.000	0.015***	0.000	0.016***	0.000
<i>ROA_t</i>	-	-0.038***	0.000	-0.039***	0.000	-0.041***	0.000
<i>SUPPORT_COST_t</i>	-	-0.019***	0.000	-0.019***	0.000	-0.019***	0.000
<i>Observations</i>		69,922		69,922		69,922	
<i>R²</i>		0.03		0.02		0.03	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Panel C: Results using the combined model

The table presents results of the regression of the form:

$$UE_{FR_{it}} = \alpha_0 + \beta_1 UE_{CAE_{it}} + \beta_2 CHARITYTYPE_{it} + \beta_3 UE_{CAE_{it}} * CHARITYTYPE_{it} + \beta_4 ROA_{it} + \beta_5 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.3)$$

Independent Variable	Prediction	Restricted		Endowment		Service	
		Coeff	P-value	Coeff	P-value	Coeff	P-value
<i>Intercept</i>		-0.259***	0.000	-0.262***	0.000	-0.250***	0.000
<i>UE_CAE_t</i>	-	-0.080***	0.000	-0.070***	0.000	-0.084***	0.000
<i>CHARITYTYPE_t</i>	?	0.0008	0.483	0.013***	0.004	-0.021***	0.000
<i>UE_CAE_t</i> <i>* CHARITYTYPE_t</i>	+	0.025***	0.004	0.036***	0.000	0.035***	0.000
<i>LOG(ASSETS_t)</i>	+	0.017***	0.000	0.017***	0.000	0.017***	0.000
<i>ROA_t</i>	-	-0.058***	0.000	-0.059***	0.000	-0.061***	0.000
<i>SUPPORT_COST_t</i>	-	-0.011**	0.011	-0.011**	0.013	-0.012***	0.008
<i>Observations</i>		58,447		58,447		58,447	
<i>R²</i>		0.04		0.04		0.04	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Variable definitions:

Variable	Definition
UE_FR_t	Unexpected fundraising costs estimated by models (1.1) McVay, (1.3) Yetman or (1.5) Combined
UE_CAE_t	Unexpected charitable activities expenses estimated by models (1.2) McVay, (1.4) Yetman or (1.6) Combined
$LOG(ASSETS_t)$	Natural logarithm of total assets in year t
ROA_t	Return (Net Income) on assets in year t
$SUPPORT_COST_t$	Support cost divided by total expenses in year t

4.5.7 Effect of ratios hypothesis (H4)

My fourth hypothesis expects a stronger negative relationship between charitable activities expenses and fundraising costs for charities that have less favourable commonly used expense ratios. Managers of a charity with a lower than the median level of programme spending ratio may have a stronger inclination towards reducing fundraising costs in favour of charitable activities expenditure. Table 4.5 shows that the interaction with a charity reporting lower programme ratio in t-1 than the median of its relevant charity subgroup further intensifies the negative relationship between UE_FR and UE_CAE . Therefore, a charity with a programme ratio in t-1 below the median of its peer group is more likely to misclassify expenses to improve its position in its peer group.

Table 4.5 shows the impact of the interaction of LOW_PR with UE_CAE as negative, which means it increases the negative relationship between UE_FR and UE_CAE (coefficient = -0.022, p-value = 0.001 using the McVay model; coefficient = -0.026, p-value = 0.000 using the Yetman model; coefficient = -0.02, p-value = 0.009 using the combined model).

However, the results for the other two expense ratios are not all significantly negative. I expect that a charity with a higher than median level of fundraising ratio in its peer group will also be incentivised to raise its charitable activities expense and reduce its fundraising costs. The unexpected fundraising and charitable activities estimated from the first stage estimation regressions employing McVay (2006) have a more significantly negative relationship when $HIGH_FR$ interacts with the main independent

variable *UE_CAE* (coefficient = -0.017, p-value = 0.000). The results are not significant using the combined model.

When fundraising efficiency ratio is used as the interaction term, it also produces mixed results. The unexpected fundraising and charitable activities estimated from the first stage estimation regressions employing McVay (2006) have a more significantly negative relationship when *HIGH_FRE* interacts with the main independent variable *UE_CAE* (coefficient = -0.019, p-value = 0.006). The results are not significant when the other two estimation regression models are used.

Table 4.5: H4 results

Regressions of *UE_FR* on *UE_CAE* interacted with firm years with less favourable expense ratios

Panel A: Results using McVay model

The table presents results of the regression of the form:

$$UE_FR_{it} = \alpha_0 + \beta_1 UE_CAE_{it} + \beta_2 RATIO_SUSPECT_{it} + \beta_3 UE_CAE_{it} * RATIO_SUSPECT_{it} + \beta_4 LOG(ASSETS_{it}) + \beta_5 ROA_{it} + \beta_6 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.4)$$

Independent Variable	Prediction	<i>LOW_PR</i>		<i>HIGH_FR</i>		<i>HIGH_FRE</i>	
		Coeff	P-value	Coeff	P-value	Coeff	P-value
<i>Intercept</i>		-0.042	0.104	-0.035	0.142	-0.011	0.377
<i>UE_CAE_t</i>	-	-0.045***	0.000	-0.046***	0.000	-0.042***	0.000
<i>RATIO_SUSPECT_t</i>	-	-0.023***	0.000	-0.023***	0.000	-0.023***	0.000
<i>UE_CAE_t</i> <i>* RATIO_SUSPECT_t</i>	-	-0.022***	0.001	-0.018***	0.008	-0.019***	0.006
<i>LOG(ASSETS_t)</i>	+	0.004*	0.051	0.003*	0.073	0.002	0.231
<i>ROA_t</i>	-	-0.048***	0.000	-0.049***	0.000	-0.049***	0.000
<i>SUPPORT_COST_t</i>	-	-0.012***	0.003	-0.013***	0.002	-0.017***	0.000
<i>Observations</i>		69,874		69,874		62,228	
<i>R²</i>		0.04		0.04		0.04	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Panel B: Results using Yetman model

The table presents results of the regression of the form:

$$UE_{FR_{it}} = \alpha_0 + \beta_1 UE_{CAE_{it}} + \beta_2 RATIO_SUSPECT_{it} + \beta_3 UE_{CAE_{it}} * RATIO_SUSPECT_{it} + \beta_4 LOG(ASSETS_{it}) + \beta_5 ROA_{it} + \beta_6 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.4)$$

Independent Variable	Prediction	LOW_PR		HIGH_FR		HIGH_FRE	
		Coeff	P-value	Coeff	P-value	Coeff	P-value
<i>Intercept</i>		-0.184***	0.000	-0.180***	0.000	-0.154***	0.000
<i>UE_CAE_t</i>	-	-0.037***	0.000	-0.044***	0.000	-0.042***	0.000
<i>RATIO_SUSPECT_t</i>	-	-0.028***	0.000	-0.032***	0.000	-0.030***	0.000
<i>UE_CAE_t</i> <i>* RATIO_SUSPECT_t</i>	-	-0.026***	0.000	-0.010*	0.055	-0.009*	0.100
<i>LOG(ASSETS_t)</i>	+	0.013***	0.000	0.013***	0.000	0.012***	0.000
<i>ROA_t</i>	-	-0.037***	0.000	-0.039***	0.000	-0.038***	0.000
<i>SUPPORT_COST_t</i>	-	-0.019***	0.000	-0.021***	0.000	-0.023***	0.000
<i>Observations</i>		69,922		69,922		62,216	
<i>R²</i>		0.02		0.02		0.02	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Panel C: Results using the combined model

The table presents results of the regression of the form:

$$UE_{FR_{it}} = \alpha_0 + \beta_1 UE_{CAE_{it}} + \beta_2 RATIO_SUSPECT_{it} + \beta_3 UE_{CAE_{it}} * RATIO_SUSPECT_{it} + \beta_4 LOG(ASSETS_{it}) + \beta_5 ROA_{it} + \beta_6 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.4)$$

Independent Variable	Prediction	LOW_PR		HIGH_FR		HIGH_FRE	
		Coeff	P-value	Coeff	P-value	Coeff	P-value
<i>Intercept</i>		-0.220***	0.000	-0.212***	0.000	-0.196***	0.000
<i>UE_CAE_t</i>	-	-0.057***	0.000	-0.065***	0.000	-0.060***	0.000
<i>RATIO_SUSPECT_t</i>	-	-0.027***	0.000	-0.029***	0.000	-0.028***	0.000
<i>UE_CAE_t</i> <i>* RATIO_SUSPECT_t</i>	-	-0.020***	0.005	-0.004	0.319	-0.006	0.223
<i>LOG(ASSETS_t)</i>	+	0.016***	0.000	0.015***	0.000	0.014***	0.000
<i>ROA_t</i>	-	-0.058***	0.000	-0.059***	0.000	-0.059***	0.000
<i>SUPPORT_COST_t</i>	-	-0.011***	0.010	-0.013***	0.005	-0.016***	0.001
<i>Observations</i>		58,447		58,447		51,976	
<i>R²</i>		0.04		0.03		0.03	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Variable definitions:

Variable	Definition
UE_FR_t	Unexpected fundraising costs estimated by models (1.1) McVay, (1.3) Yetman or (1.5) Combined
UE_CAE_t	Unexpected charitable activities expenses estimated by models (1.2) McVay, (1.4) Yetman or (1.6) Combined
$LOG(ASSETS_t)$	Natural logarithm of total assets in year t
ROA_t	Return (Net Income) on assets in year t
$SUPPORT_COST_t$	Support cost divided by total expenses in year t
$HIGH_FR_t$	Dummy variable equal to 1 if the charity has higher than the median level of fundraising ratio in year t-1. Where Fundraising ratio is defined as Fundraising expenses divided total expenses in year t
LOW_PR_t	Dummy variable equal to 1 if the charity has lower than the median level of programme ratio in year t-1. Where Programme expense ratio is defined as Charitable activities expenses divided by total expenses in year t
FRE_RATIO_t	Dummy variable equal to 1 if the charity has lower than the median level of fundraising efficiency ratio in year t-1. Fundraising efficiency ratio: Fundraising expense divided fund raising income in year t.
UE_FR_t	Unexpected fundraising costs estimated by models (1.1) McVay, (1.3) Yetman or (1.5) Combined
UE_CAE_t	Unexpected charitable activities expenses estimated by models (1.2) McVay, (1.4) Yetman or (1.6) Combined
$Sophisticated_t$	Dummy variable equal to 1 if the charity has above-median restricted funds within its respective nonprofit classification, and 0 otherwise.
$Endowment_t$	Dummy variable equal to 1 if the charity has above-median endowment fund ratio end of year endowment fund divided by total funds) within its respective nonprofit classification, and 0 otherwise.
$Service_t$	Dummy variable equal to 1 if the charity has above-median program service revenue to total revenue within its respective nonprofit classification, and 0 otherwise.

4.5.8 Support cost hypothesis (H5)

The final hypothesis expects a stronger negative relationship between charitable activities expenses and fundraising costs for the charities that have higher than the median level of charity administration expenditure in the reporting year. Table 4.6 shows that the interaction increases the negative relationship between UE_FR and UE_CAE , only if the Yetman estimation model is employed. The results are not

significant for regressions using the other two estimation models. The interaction effect using the Yetman model is coefficient = -0.014, p-value = 0.040.

This shows that the effect of higher than median support cost is either absent or very weak. The prior literature does not directly hypothesise that a high level of support cost is certain to lead to a raised likelihood of manipulation. Hence it would be safe to accept that only a large amount of support cost should not on its own be a reason to develop doubts about the intentions and expense reporting quality of a charity.

Table 4.6: H5 results

Regressions of UE_FR on UE_CAE interacted with firm years including high support costs

Panel A: Results using McVay model

The table presents results of the regression of the form:

$$UE_FR_{it} = \alpha_0 + \beta_1 UE_CAE_{it} + \beta_2 HIGH_SC_{it} + \beta_3 UE_CAE_{it} * HIGH_SC_{it} + \beta_4 LOG(ASSETS_{it}) + \beta_5 ROA_{it} + \beta_6 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.5)$$

Independent Variable	Prediction	HIGH_SC	
		Coeff	P-value
<i>Intercept</i>		-0.094***	0.003
<i>UE_CAE_t</i>	-	-0.053***	0.000
<i>HIGH_SC_t</i>	-	-0.006***	0.001
<i>UE_CAE_t * HIGH_SC_t</i>	-	-0.010	0.115
<i>LOG(ASSETS_t)</i>	+	0.006***	0.002
<i>ROA_t</i>	-	-0.049***	0.000
<i>SUPPORT_COST_t</i>	-	-0.004	0.213
<i>Observations</i>		69,874	
<i>R²</i>		0.04	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Panel B: Results using Yetman model

The table presents results of the regression of the form:

$$UE_{FR_{it}} = \alpha_0 + \beta_1 UE_{CAE_{it}} + \beta_2 HIGH_{SC_{it}} + \beta_3 UE_{CAE_{it}} * HIGH_{SC_{it}} + \beta_4 LOG(ASSETS_{it}) + \beta_5 ROA_{it} + \beta_6 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.5)$$

Independent Variable	Prediction	HIGH_SC	
		Coeff	P-value
<i>Intercept</i>		-0.236***	0.000
<i>UE_CAE_t</i>	-	-0.046***	0.000
<i>HIGH_SC_t</i>	-	-0.008***	0.000
<i>UE_CAE_t * HIGH_SC_t</i>	-	-0.014**	0.041
<i>LOG(ASSETS_t)</i>	+	0.016***	0.000
<i>ROA_t</i>	-	-0.038***	0.000
<i>SUPPORT_COST_t</i>	-	-0.010**	0.040
<i>Observations</i>		69,922	
<i>R²</i>		0.03	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Panel C: Results using the combined model

The table presents results of the regression of the form:

$$UE_{FR_{it}} = \alpha_0 + \beta_1 UE_{CAE_{it}} + \beta_2 HIGH_{SC_{it}} + \beta_3 UE_{CAE_{it}} * HIGH_{SC_{it}} + \beta_4 LOG(ASSETS_{it}) + \beta_5 ROA_{it} + \beta_6 SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.5)$$

Independent Variable	Prediction	HIGH_SC	
		Coeff	P-value
<i>Intercept</i>		-0.266***	0.000
<i>UE_CAE_t</i>	-	-0.066***	0.000
<i>HIGH_SC_t</i>	-	-0.006***	0.001
<i>UE_CAE_t * HIGH_SC_t</i>	-	-0.005	0.289
<i>LOG(ASSETS_t)</i>	+	0.018***	0.000
<i>ROA_t</i>	-	-0.059***	0.000
<i>SUPPORT_COST_t</i>	-	-0.003	0.285
<i>Observations</i>		58,447	
<i>R²</i>		0.04	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Variable definitions:

Variable	Definition
UE_FR_t	Unexpected fundraising costs estimated by models (1.1) McVay, (1.3) Yetman or (1.5) Combined
UE_CAE_t	Unexpected charitable activities expenses estimated by models (1.2) McVay, (1.4) Yetman or (1.6) Combined
$LOG(ASSETS_t)$	Natural logarithm of total assets in year t
ROA_t	Return (Net Income) on assets in year t
$SUPPORT_COST_t$	Support cost divided by total expenses in year t
$HIGH_SC_t$	Dummy variable equal to 1 if the charity has higher than the median level of $SUPPORT_COST$ (Support cost in year t).

I conduct below supplemental tests to examine the robustness of my main results and run additional regressions to further understand the impact of the suspect variables on various charity types.

4.5.9 Additional analysis

In my additional analysis I employ triple interaction involving LOW_PR (low programme ratio) with charity and donor types. I select LOW_PR as it provided more conclusive results in my main analysis using all three models. The results are shown in Table 4.7 for the following empirical model.

$$\begin{aligned}
 UE_FR_{it} = & \alpha_0 + \beta_1 UE_CAE_{it} + \beta_2 LOW_PR_{it} + \beta_3 CHARITYTYPE_{it} + \beta_4 UE_CAE_{it} * LOW_PR_{it} + \\
 & \beta_5 UE_CAE_{it} * CHARITYTYPE_{it} + \beta_6 LOW_PR_{it} * CHARITYTYPE_{it} + \beta_7 UE_CAE_{it} * LOW_PR_{it} * \\
 & CHARITYTYPE_{it} + \beta_8 LOG(ASSETS_{it}) + \beta_9 ROA_{it} + \beta_{10} SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.6)
 \end{aligned}$$

I report the results using all three estimation models in Panels A, B and C of Table 4.7.

Given that the results in my main analyses indicate that managers appear to be incentivised to report a low programme ratio, I further study whether programme ratio adversely impacts the expense manipulation behaviour by the three different types of charities: sophisticated, endowment and service-oriented.

I predict that the interaction coefficient would be negative when a sophisticated or service-oriented charity type is interacted with UE_CAE . An interaction of low programme ratio and UE_CAE is also predicted to have a negative sign. On the contrary a triple interaction will not have a directional prediction as it would depend on

whether the low programme ratio is a more powerful reason to manipulate than the deterrence caused by the sophistication and low donor-beneficiary separation.

Table 4.7 shows that the LOW_PR interaction increases the negative relationship between UE_FR and UE_CAE even for the nonprofits that receive higher funding from restricted donations. This means that the overall positive coefficient becomes much smaller for a charity with sophisticated donors if its programme ratio in the previous year is below median. However due to the presence of sophisticated funders the overall impact remains lower than the baseline charity that does not have added pressure to manipulate due to an unwanted programme ratio. Using the McVay (2006) estimation model, I observe a negative effect from having both a low programme ratio and restricted donations of -0.027 (p-value = 0.034) using the McVay model and -0.026 (p-value = 0.043) using the combined model. The results using the Yetman model are not significant, alluding to no impact of programme ratio on the preparedness for manipulation by sophisticated charities.

The next column of results in Table 4.7 examine the effect of endowment charities on manipulative behaviour of nonprofits with low programme ratio. I find that the charities with higher endowment funds are less incentivised to misclassify. This is consistent with the main analysis as endowed charities tend to have closer monitoring by its patrons. The interaction term *UE_CAE*LOW_PR*CHARITYTYPE* is 0.039 and significant using the McVay model, and 0.05 and significant using the combined model. The results using the Yetman model also support the results where a weakly insignificant (p<0.11) reduction in the baseline negative coefficient is noted by 0.031. This signals that the restrictive impact of endowment funds overpowers the motivation to misclassify in response to low programme ratio.

The results using all three models suggest that for a charity with higher endowment there is less likelihood for expense misclassification even if the programme ratio is lower than the median in t-1. I infer from it that there will be a more stringent monitoring for an endowed charity with low programme spending in the previous year, it would therefore be less prone to misguiding through expense manipulation.

The third column shows the results from interacting with service-oriented charities. The results using the service-oriented charity type variable present a different story. The output from all three estimation models show that the LOW_PR increases the

negative aggregate coefficient for service-oriented types. Specifically, the high programme ratio increases the negative correlation between UE_FR and UE_CAE more so in service-oriented firms (interaction coefficient of -0.043, p-value = 0.003 using the McVay model; coefficient = -0.039, p-value = 0.000 using the Yetman model; coefficient = -0.045, p-value = 0.003 using the combined model).

Table 4.7: Programme ratio - additional results

Regressions of UE_FR on UE_CAE interacted with firm years including low programme ratios and charity types

Panel A: Results using McVay model

The table presents results of the regression of the form:

$$UE_FR_{it} = \alpha_0 + \beta_1 UE_CAE_{it} + \beta_2 LOW_PR_{it} + \beta_3 CHARITYTYPE_{it} + \beta_4 UE_CAE_{it} * LOW_PR_{it} + \beta_5 UE_CAE_{it} * CHARITYTYPE_{it} + \beta_6 LOW_PR_{it} * CHARITYTYPE_{it} + \beta_7 UE_CAE_{it} * LOW_PR_{it} * CHARITYTYPE_{it} + \beta_8 LOG(ASSETS_{it}) + \beta_9 ROA_{it} + \beta_{10} SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.6)$$

Independent Variable	Prediction	Sophisticated		Endowment		Service	
		Coeff	P-value	Coeff	P-value	Coeff	P-value
<i>Intercept</i>		-0.036	0.134	-0.040	0.116	-0.025	0.226
<i>UE_CAE_t</i>	-	-0.064***	0.000	-0.046***	0.000	-0.064***	0.000
<i>LOW_PR_t</i>	-	-0.027***	0.000	-0.025***	0.000	-0.021***	0.000
<i>CHARITYTYPE_t</i>	?	-0.005***	0.008	0.000	0.475	-0.020***	0.000
<i>UE_CAE_t * LOW_PR_t</i>	-	-0.006	0.308	-0.025***	0.001	-0.001	0.464
<i>UE_CAE_t * CHARITYTYPE_t</i>	+	0.035***	0.000	0.020**	0.027	0.039***	0.000
<i>LOW_PR_t * CHARITYTYPE_t</i>	?	0.008***	0.003	0.017***	0.000	-0.003	0.124
<i>UE_CAE_t * LOW_PR_t * CHARITYTYPE_t</i>	?	-0.027**	0.034	0.039***	0.003	-0.043***	0.003
<i>LOG(ASSETS_t)</i>	+	0.003*	0.059	0.003*	0.059	0.003*	0.072
<i>ROA_t</i>	-	-0.047***	0.000	-0.047***	0.000	-0.048***	0.000
<i>SUPPORT_COST_t</i>	-	-0.013***	0.003	-0.012***	0.003	-0.013***	0.002
<i>Observations</i>		69,874		69,874		69,874	
<i>R²</i>		0.04		0.04		0.05	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Panel B: Results using Yetman model

The table presents results of the regression of the form:

$$\begin{aligned}
 UE_{FR_{it}} = & \alpha_0 + \beta_1 UE_{CAE_{it}} + \beta_2 LOW_{PR_{it}} + \beta_3 CHARITYTYPE_{it} + \beta_4 UE_{CAE_{it}} * LOW_{PR_{it}} + \\
 & \beta_5 UE_{CAE_{it}} * CHARITYTYPE_{it} + \beta_6 LOW_{PR_{it}} * CHARITYTYPE_{it} + \beta_7 UE_{CAE_{it}} * LOW_{PR_{it}} * \\
 & CHARITYTYPE_{it} + \beta_8 LOG(ASSETS_{it}) + \beta_9 ROA_{it} + \beta_{10} SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.6)
 \end{aligned}$$

Independent Variable	Prediction	Sophisticated		Endowment		Service	
		Coeff	P-value	Coeff	P-value	Coeff	P-value
<i>Intercept</i>		-0.180***	0.000	-0.179***	0.000	-0.172***	0.000
<i>UE_CAE_t</i>	-	-0.049***	0.000	-0.037***	0.000	-0.060***	0.000
<i>LOW_PR_t</i>	-	-0.034***	0.000	-0.032***	0.000	-0.028***	0.000
<i>CHARITYTYPE_t</i>	?	-0.003*	0.068	-0.002	0.299	-0.027***	0.000
<i>UE_CAE_t * LOW_PR_t</i>	-	-0.020**	0.028	-0.027***	0.000	-0.004	0.333
<i>UE_CAE_t * CHARITYTYPE_t</i>	+	0.024***	0.001	0.001	0.471	0.043***	0.000
<i>LOW_PR_t * CHARITYTYPE_t</i>	?	0.011***	0.000	0.022***	0.000	-0.001	0.367
<i>UE_CAE_t * LOW_PR_t * CHARITYTYPE_t</i>	?	-0.011	0.185	0.031	0.106	-0.039***	0.002
<i>LOG(ASSETS_t)</i>	+	0.013***	0.000	0.013***	0.000	0.014***	0.000
<i>ROA_t</i>	-	-0.036***	0.000	-0.036***	0.000	-0.038***	0.000
<i>SUPPORT_COST_t</i>	-	-0.019***	0.000	-0.019***	0.000	-0.019***	0.000
<i>Observations</i>		69,922		69,922		69,922	
<i>R²</i>		0.03		0.02		0.03	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Panel C: Results using the combined model

The table presents results of the regression of the form:

$$\begin{aligned}
 UE_{FR_{it}} = & \alpha_0 + \beta_1 UE_{CAE_{it}} + \beta_2 LOW_{PR_{it}} + \beta_3 CHARITYTYPE_{it} + \beta_4 UE_{CAE_{it}} * LOW_{PR_{it}} + \\
 & \beta_5 UE_{CAE_{it}} * CHARITYTYPE_{it} + \beta_6 LOW_{PR_{it}} * CHARITYTYPE_{it} + \beta_7 UE_{CAE_{it}} * LOW_{PR_{it}} * \\
 & CHARITYTYPE_{it} + \beta_8 LOG(ASSETS_{it}) + \beta_9 ROA_{it} + \beta_{10} SUPPORT_COST_{it} + \varepsilon_{it} \quad (4.6)
 \end{aligned}$$

Independent Variable	Prediction	Sophisticated		Endowment		Service	
		Coeff	P-value	Coeff	P-value	Coeff	P-value
<i>Intercept</i>		-0.214***	0.000	-0.213***	0.000	-0.202***	0.000
<i>UE_CAE_t</i>	-	-0.076***	0.000	-0.057***	0.000	-0.084***	0.000
<i>LOW_PR_t</i>	-	-0.032***	0.000	-0.030***	0.000	-0.027***	0.000
<i>CHARITYTYPE_t</i>	?	-0.004**	0.019	0.001	0.464	-0.022***	0.000
<i>UE_CAE_t * LOW_PR_t</i>	-	-0.006	0.319	-0.024***	0.002	0.004	0.386
<i>UE_CAE_t * CHARITYTYPE_t</i>	+	0.036***	0.000	0.008	0.318	0.056***	0.000
<i>LOW_PR_t * CHARITYTYPE_t</i>	?	0.009***	0.002	0.021***	0.000	0.0001	0.484
<i>UE_CAE_t * LOW_PR_t * CHARITYTYPE_t</i>	?	-0.026**	0.043	0.050***	0.007	-0.045***	0.003
<i>LOG(ASSETS_t)</i>	+	0.015***	0.000	0.015***	0.000	0.015***	0.000
<i>ROA_t</i>	-	-0.057***	0.000	-0.057***	0.000	-0.059***	0.000
<i>SUPPORT_COST_t</i>	-	-0.012***	0.009	-0.011***	0.010	-0.012***	0.007
<i>Observations</i>		58,447		58,447		58,447	
<i>R²</i>		0.04		0.04		0.04	

*, **, *** Represent significance levels of 10 percent, 5 percent, and 1 percent, respectively.

Variable definitions:

Variable	Definition
UE_FR_t	Unexpected fundraising costs estimated by models (1.1) McVay, (1.3) Yetman or (1.5) Combined
UE_CAE_t	Unexpected charitable activities expenses estimated by models (1.2) McVay, (1.4) Yetman or (1.6) Combined
$LOG(ASSETS_t)$	Natural logarithm of total assets in year t
ROA_t	Return (Net Income) on assets in year t
$SUPPORT_COST_t$	Support cost divided by total expenses in year t
UE_FR_t	Unexpected fundraising costs estimated by models (1.1) McVay, (1.3) Yetman or (1.5) Combined
UE_CAE_t	Unexpected charitable activities expenses estimated by models (1.2) McVay, (1.4) Yetman or (1.6) Combined
$Sophisticated_t$	Dummy variable equal to 1 if the charity has above-median restricted funds within its respective nonprofit classification, and 0 otherwise.
$Endowment_t$	Dummy variable equal to 1 if the charity has above-median endowment fund ratio end of year endowment fund divided by total funds) within its respective nonprofit classification, and 0 otherwise.
$Service_t$	Dummy variable equal to 1 if the charity has above-median program service revenue to total revenue within its respective nonprofit classification, and 0 otherwise.
LOW_PR_t	Dummy variable equal to 1 if the charity has lower than the median level of programme ratio in year t-1.

4.6 Robustness Tests

In the following section, I present results from a number of sensitivity tests to confirm the robustness of my findings in the above analyses. I do not tabulate the results of the robustness tests but their findings are discussed below.

4.6.1 Alternative charity categories

In the main analyses, I define charities using earlier studies (e.g. Balsam and Harris, 2014) where a charity above (below) the median level of programme revenue in its charity subgroup is coded as service-oriented (charitable). Similarly, charities above (below) the median level of restricted funds in their respective subgroups are coded as sophisticated (less sophisticated). As robustness, I use continuous variables to mitigate the subjectivity in assigning a specific threshold of the median value by interacting programme service revenue (PSR) with UE_CAE and the results are positively significant, confirming that an increase in the level of programme income, (or charitable activities income) decreases the likelihood of expense shifting. I also

interact the level of 'Restricted funds' with UE_CAE and the results are positively significant, confirming that an increase in the level of restriction also decreases the likelihood of expense shifting.

4.6.2 Alternative definition of suspect firms

The most important suspect variable that I examine above is a high programme ratio. To ensure a lower programme ratio in t-1 is a robust variable to test hypothesis 4, I employ substitute variables and run the regressions with the same control and charity type variables. First, I interact the change in programme ratio from t-1 to t and then from t-2 to t-1 to test whether a downwards change in programme ratio exacerbates misclassification behaviour. The results are robust and the relationship appears positive, implying that an increase in programme ratio will reduce the negative relationship between UR_FR and UE_CAE, hence confirming that a reduction in programme ratio must increase the likelihood of expense misclassification. I also employ triple interaction with the charity and donor types and observe similar results. The results for a the sophisticated CHARITYTYPE and endowment CHARITYTYPE are not significant, confirming that sophistication and monitoring of donors deters expense misclassification, but that the charity type is not enough to resist the pressure created by a high programme ratio.

I also create as a dummy variable which takes the value of 1 if the programme ratio has decreased from t-1 (t-2) to t (t-1) and 0 otherwise. The results are in line with my main tests, using the simple interaction with UE_CAE and triple interactions involving the charity types, based on the change in the ratio from t-1 to t. If the change in ratio is negative then it is expected that such charity would be more incentivised to manipulate its expense classification.

4.6.3 Alternative CAE variable

My main regression has the independent variable CAE, which is measured as the sum of charitable activities expenses and grants to other institutions. I believe this variable must include both as grants are paid by foundation charities and fall within the definition of programme related expenses. However, I also remove the grants to other institutions figures from my variable and the results remain predominantly similar, although the coefficients are much smaller.

4.6.4 Alternative deflator

The variables in the main study are deflated by lagged total assets. To test the robustness of my tests following McVay (2006), I use total income as the deflator. The results remain qualitatively similar to those in the main tests. I also use total assets in $t-1$, log of total assets in $t-1$ and ROA as deflators. Again the results and signs for the variable of importance are similar to my main analyses.

4.6.5 Alternative control variables

Following Leone and Van Horne (2005), I include the lagged variable UE_FR as an independent variable and the signs remain the same; inferences remain unaffected. Similarly, I also remove the control variables either completely or one by one from the main regressions and find that the main variables of interest remain significant with the identical signs to the original analyses.

4.6.6 Alternative UE_FR and UE_CAE prediction variables

Although 3 models have been used to predict the two, I also use only the lagged versions of FR and CAE to predict the normal levels of the two variables. The results are consistent with those reported under the main analyses.

4.6.7 Alternative measure of high support cost

The results of Hypothesis 5 were mostly insignificant and therefore I am unable to reject the null hypothesis and accept the alternative hypothesis that higher than median support costs motivates management to misclassify their expenses more. I test this conclusion through further sensitivity tests by defining the HIGH_SC differently. I run the regressions by interacting three different substitutes for HIGH_SC with UE_CAE and CHARITYTYPE. These alternative proxies are (a) the change in support cost from $t-1$ to t , (b) a substitute dummy variable that takes the value of 1 if support cost has increased from $t-1$ to t , and 0 otherwise, and (c) a dummy variable that takes the value of 1 if support cost is higher than the median in $t-1$, and 0 otherwise. All results are mostly insignificant, confirming that a mere increase in support costs does not on its own lead to a higher likelihood of expense misclassification.

I also test for the variance inflation factor (VIF) which indicates the magnitude of the inflation in the standard errors due to multicollinearity. The mean VIF for the combined estimation regression is 1.61 with the highest one for log total assets at 3.10.

Consistent with the prior literature, size (Total Assets) is significantly correlated with many other control variables (e.g. Balsam and Harris, 2014). The extant literature recognises that total assets can have a relatively higher VIF, given that it is used as a deflator. A VIF above 10 represents high multicollinearity (Belsley et al., 1980), whereas Rogerson, (2001) recommend a maximum VIF value of 5. I find that none of the variance inflation factors except for the interaction variables is over 4.0.

One of the primary results is that the relationship between unexpected fundraising costs and unexpected charitable activities expenses is negative. Following the robustness tests, it does not appear that these results are due to a mechanical relationship or misspecified estimation of the unexpected expense variables. Mechanically, nothing is preventing the unexpected levels of the two expenses to move in the same direction. When the total expense in a certain period become unexpectedly higher or lower than the norm then it may result in both moving in the same direction. Studying the impact on manipulation by considering various measures for expense efficiency, I provide evidence that programme ratio is the most commonly pursued measure by nonprofit managers that warrants misclassification of expenses.

4.7 Conclusion

This paper examines misclassification between fundraising and charitable activities expenses within the Statement of Financial Position of nonprofits. Misclassification is a tool to misrepresent a nonprofit's allocation of resources between its main objectives and the less favoured costs, the fundraising activities. I take inspiration from for-profit and nonprofit literature to design this research. Compared to classification shifting in for-profit firms, nonprofits are scrutinised more by media and the public to allocate most of their resources to the main charitable purpose for what a nonprofit exists for. This paper observes and reports that such misallocation does take place. Hence it is an important study that should interest regulators, donors and nonprofit managers. This can guide the regulator for policy formulation regarding how the expenses are recognised and reported, the donors to appreciate that charities in many cases feel almost compelled due to their unrealistic expectations, which in some cases leads to expense misreporting, and nonprofit management that such expense misclassification can lead to a loss in income. The unexpected levels of fundraising and charitable expenses can be observed and considering the extant literature, donors are tentative

in donating to a charity with low expense reporting quality. Hence misclassification can achieve quite the opposite to what it is intended for.

I examine classification shifting between fundraising expenses (for promotion, salary or commission to fundraisers, reimbursements to volunteers etc.) and charitable activities expenses, the main purpose for which a nonprofit exists. I do not make judgments on whether the fundraising costs are excessive. In the current competitive climate, it is challenging for charities to raise funds for programme costs, let alone raising funds for fundraising expenses from public and private sources.

This study contributes to the positive accounting theory and refrains from stumbling into the normative theory by pontificating on fairness and legitimacy of the expense levels. However, I understand the relentless pressures to raise funds which lead to the pressures to misclassify expenses. I observe expense misclassification with varying degrees depending on the levels of motivations and monitoring. Although I believe the results persuasively show that types of funders and charities are important factors in predicting whether a charity is susceptible to misclassifying its expenses, the evidence by interacting the prevailing expense ratios is mixed. Similarly, the level of support cost does not seem to have a significant impact on the readiness to shift expense classification.

Adapting to the models by McVay (2006) and Yetman and Yetman (2012, 2013), I employ three models to predict normal levels of fundraising and charitable activities expenses. I find that unexpected fundraising costs are significantly negatively associated with charitable activities expenses using all three models. Furthermore, I find this shifting to be less prominent when a charity is funded more by sophisticated funders, i.e. those who a) place restrictions on their donations and b) pay endowment funds. Similarly, if a charity is more service-oriented, i.e. it receives a higher level of programme revenue then it is observed to manipulate less. This may be because the donor-beneficiary separation is low and managers are comparatively less motivated to misguide through financial reporting. The donors can observe the level and quality of services directly, hence the relevance of such manipulation is lower than in those charities which receive a lower degree of programme revenue.

This study also classifies the sample into suspect and non-suspect groups. The nonprofit with higher than the median levels of programme expense, fundraising

efficiency and fundraising cost ratios in t-1 are classified as suspect. I hypothesise that all such firm years will be more prone to misclassify. I find that of all the ratios, programme ratio appears to be the one which nonprofit managers fixate on most, even for a more service-oriented charity. Programme ratio is a simple measure that presents the percentage spending on the main charitable causes compared to the total resources expended in a period.

Contrary to my initial expectation, I find that higher than the median of support cost in the current year is not strong enough a reason to convince managers to misclassify between fundraising and charitable activities expenses. The expectation that simply having high support cost could be amenable to misclassification is based on the assumption that all support costs are disapproved of by donors. It is perhaps an indication that donors and nonprofit managers are becoming aware and more accepting that a charity needs to have support costs to run its operations. A mere presence of support cost must not be regarded as an antecedent for expense classification shifting.

While my methodology has considered several predictor variables in various ways, the possibility that simultaneity or confounding variables influence my results cannot be ruled out. However, a large degree of this concern has been addressed through several robustness tests as mentioned above. It is important to note that this study and its various analyses are a first step in exploring the misclassification between expenses. Therefore, it should not be interpreted as conclusive evidence that the charities can be neatly classified into their respective groups. Also, it would be wrong to assume that all charities other than those falling outside the sophisticated or service-oriented categories are more amenable to expense misclassification, or that an apparently less favourable expense ratio is a forerunner for classification shifting.

Chapter 5: Conclusion

5.1 Introduction

This thesis comprises three studies in financial reporting manipulation in UK charities. The first study uses the qualitative method of semi-structured interviews with professionals suggesting several motivations for financial reporting manipulation. The motivations are found to be aiming for a small surplus as well as minimising fundraising ratios. This study also questions whether UK charities manage their earnings to a target range and if they misclassify their expenses to appear more legitimate. The motivations for earnings management and misclassification of expenses add to the scant literature fully dedicated to motivations, using the qualitative technique. The extant studies have predominantly focused on earnings management using US data employing quantitative techniques.

The second study examines accrual-based and real earnings management using traditional quantitative techniques. The limited extant literature does not examine the extent of real and accruals earnings management in nonprofits according to their sophistication and donor-beneficiary proximity level.

Finally, the third study is the first to examine expense misclassification in UK charities. Using three different methods, it estimates normal levels of fundraising and charitable activities expenses and uses their abnormal levels as proxies of misclassification. This methodology is the first which studies the classification shifting between the two major types of expenses. It tests whether charities' willingness to shift the expenses between the two major expense categories is determined by the sophistication and donor-beneficiary proximity. The main results and their implications are summarised in the following sections.

5.2 Motivations for financial misreporting by UK charities

Chapter 2 first investigates the motivators of financial misreporting in UK charities. This is the first qualitative study to my knowledge that is based on interviews with preparers of financial statements. This technique makes a valuable addition to the literature given the difficulty involved in hearing from the preparers of financial statements about misreporting. The richness of data does not only confirm that UK charities are willing to misreport in their financial statements, but it also adds to the list

of known motivators for misreporting. The predominant factor that managers attribute to in misreporting is the concern that donors view certain numbers unfavourably. Large surpluses, a deficit, high levels of reserves, low financial viability, high fundraising raising ratios and low programme ratios are undesirable and are viewed unfavourably by existing and potential donors. Therefore, managers are expected to undertake earnings management and expense misclassification to 'adjust' the numbers to favourable and 'normal' levels. The principal motivation for this misreporting is the continuance of funding into and beyond the foreseeable future. There are also various subordinate motivations that collectively lead to the overarching goal of sustainable funding as donors react adversely to high fundraising costs (Okten and Weisbrod, 2000). Amongst the factors that contribute to such motivation are: a) The preparers of financial statements and auditors in my data agree that high levels of reserves are an important factor to put off the donors, which may result in crowding-out (e.g. Abrams and Schmitz, 1978, 1984; Daws and Thaler, 1988); b) The rising overheads puts pressure on charity managers to allocate more to charitable activities, as it is seen as a more favourable class of expenses; c) Shifting trends from voluntary to earned income poses a complex set of challenges as charities would also want to be seen 'financially viable' increasing the need to avoid sustained deficits and consistently depleting reserves. Similarly, it would contribute to the pressure for peer benchmarking to vie with competitors in winning bids for contracts; d) Debt covenants; although they appear to be less in the nonprofit sector, (perhaps due to higher costs associated with it such as interest and monitoring) I find evidence that a charity faced with debt covenants will more likely manage earnings to a small surplus and avoid running out of reserves; e) The concern for professional reputation and career mobility cause further pressure of being 'judged' and seen as associated with a charity which is legitimate, financially secure and fulfilling its objectives. This also supports the extant literature that suggests changes in compensation are positively associated with changes in programme spending (Baber et al., 2002) and that managers pursue high programme ratios (e.g. Tinkelman 1998; Baber et al., 2001, Trussel, 2003, Jones and Roberts 2006; Krishnan et al. 2006; Keating et al. 2008, Tinkelman, 2009; Parsons et al., 2012); f) Less sophisticated users of financial statements, who are either not fully cognizant with charity accounting peculiarities or perhaps do not appropriately study a charity's financial performance and position in light of its specific priorities, policies and circumstances, are another source compelling nonprofits to 'adjust' the numbers

to 'legitimate' and 'normal' levels; g) Income and expense mismatch in various periods creates issues for managers too. The accruals concept is at the heart of accounting and to appear consistent and stable (without large peaks and troughs in the bottom-line figure) charities are motivated to 'smooth' their financial performance.

In addition to the above motivators, the study also identifies 'facilitators' that increase the likelihood of turning the motivation into actual manipulation. When users cannot detect manipulation or the cost to manipulate is lower than the benefit associated with it (Matsumoto, 2002) then it is more likely that a charity will manage earnings and/or misclassify expenses. The study finds that the audit quality in the sector is generally inferior and facilitates manipulation as incentives for financial statements manipulation are enhanced if the chance of their detection is low (Wayne et al., 1996). The auditors appear to be aware of the challenges faced in auditing the sector due to lower audit fees, hence less time to plan the audits. Furthermore, inexperienced trustees and top management are other factors that facilitate misreporting. This finding also supports the argument in the extant literature that management's honest behaviour regarding its assets is negatively associated with the independence of key individuals (Harris, 2017). Lastly, unsophisticated donors are another reason that exacerbate the likelihood of manipulation because they are not expected by management to fairly scrutinise the financial statements themselves. In their place, the media judge charities according to certain "acceptable" benchmarks, which are relatively superficial and less specific to a charity's priorities, policies and circumstances.

5.3 Earnings management in charities

Using quantitative techniques, chapter 3 examines whether UK charities manage earnings to a small surplus level as reported in the existing literature (e.g. Leone and Van Horn, 2005; Ballantine et al., 2007; Verbruggen and Christiaens, 2012) and confirmed by the first study of this thesis. Chapter 3 includes tests to examine accruals-based and real earnings management by UK charities. In addition, it studies the effect of sophistication and charity type in relation to its service-orientation. The study finds that nonprofits avoid large surplus or deficits using real and accrual-based earnings management techniques. It also finds that sophistication and donor-beneficiary distance do indeed have an impact on the propensity of manipulation as well as the choice of the earnings management types. The charities funded by sophisticated

donors, either due to larger restricted funds or larger endowment funds, are less likely to manage earnings using either accounting-based or real activities-based techniques. The service-oriented charities that receive higher income through programme service revenue from government grants or contracts appear less likely to employ real accounts management, by reducing spending on fundraising, in pursuit of a small surplus. A low donor-recipient separation may explain this because abnormal changes to fundraising costs are more likely to be noticed by the users of services who also happen to be a charity's source of funding. As accruals-based earnings management is employed at the year-end, it remains less noticeable for the funders who, because of having access to several other sources of information, are less likely to turn to the financial statements at year-end. Conceivably, a low preference for real accounts manipulation signals mindfulness of adverse effects of curtailing necessary fundraising costs as opposed to a pure accounting-based earning management. The second study also suggests that larger charities are less likely to manage earnings by altering fundraising costs, either because they are simply unable to shed a portion of their regular fixed costs or because their sophisticated management finds this to be a more dysfunctional route.

5.4 Expense misclassification in charities

Study 3 in chapter 4 examines expense misclassification in charities, contributing to literature on expense misclassification in general and for the charity sector in particular. This study confirms earlier research that in response to the donor dislike for high fundraising costs nonprofits shift costs into the programme expense (e.g. Baber et al., 2001; Khumawala et al. 2005; Krishnan et al., 2006; Keating et al., 2008; Krishnan and Yetman, 2011; Parsons et al., 2017). Using three different techniques to estimate normal levels of fundraising and charitable expenses I produce similar results and hence assured inferences. In the first stage estimation regressions of the study, I calculate normal or expected levels of fundraising and charitable activities costs, using the variables contained in (a) McVay (2006) and (b) Yetman and Yetman (2012, 2013). I also use a combined model including all variables in (a) and (b).

The study presents evidence of expense classification shifting in UK charities. For the first time, a strong negative relationship between unexpected levels of fundraising and unexpected charitable activities expenses is identified. This points to expense misclassification between the two expense categories. All charity types as used in

Balsam and Harris (2014) on the whole shift expenses between the two categories. However, the level of such misclassification is less prevalent in some types compared to others. Similar to the finding in the second study the strength of such manipulation is likely to be weaker for a charity funded by sophisticated funders. This is shown through a less negative relationship between the unexpected levels of fundraising and charitable activities costs for the nonprofits supported by more sophisticated funders. Similarly, I confirm the results in the first study that low donor-beneficiary separation mitigates against expense misclassification. This confirms the findings in the prior literature that nonprofit organisations that depending on donations are more likely to manage ratios to report maximum programme spending (e.g. Jones & Roberts, 2006; Krishnan et al., 2006; Keating et al., 2008). Amongst the expense ratios, a low programme ratio is more likely a stronger motivation to manipulate. Contrary to my expectation from the first study, that rising overhead costs motivate managers to manipulate, I do not find evidence that high support cost on its own does indeed compel managers to misclassify.

5.5 Limitations and further research

This study has provided useful evidence to add to the current body of knowledge and paves a path for future research with other research designs to further confirm my findings. This study has societal relevance as it boosts confidence in earnings quality of the charities funded by donors that are more sophisticated: those that place restrictions on the use of their donations. Also, it highlights an overall less preparedness by service-oriented charities to cook the books. This being the first study of its kind poses more questions than it answers.

Qualitative studies looking into each type of charity subgroups, sophistication levels and charity type vis-à-vis donor-beneficiary distance will further clarify the complexities involved and paradoxes faced by charities when there are multiple types of financial supporters. It would be a useful addition to the literature if the competing forces are analysed and stronger pullers are identified. Further hand-collected data in addition to the available data can look into the corporate governance-related aspects and their influence on financial misreporting. The quantitative study contained in his thesis can also be improved by using more hand-control collected variables.

It is, however, necessary that I include some limitations of this study. One limitation of this study is that I have independently investigated different types of accounting manipulation that charities are suspected to undertake. However, I understand that many other driving forces could influence the expense manipulation and earnings management. These could include individual charity circumstances such as chief executive's compensation contracts, details of which are not easily identifiable, precise details of debt covenants and the mix of income sources and the varying demands of different sub-groups of financial supporters. The second limitation is that although I have followed extant literature in classifying the charities vis-à-vis sophistication and more service-oriented types, in practice, lines may be rather blurred and less distinct. Similarly, there are other factors which influence donor giving and they do not simply depend on ratios; some donors may use financial statements more than others. However this research does not claim to predict donor response to less palatable ratios and earnings figures; rather it reports what management appears to believe. It is the author's understanding that the management of a charity would mostly act according to the perceived preferences of its respective donors. The author also feels the need for further research to understand whether management's assumptions are primarily based on theoretical expectations or have a link with anecdotal evidence concerning their charities. The interviews in the first study, do however lead to a possibility that many managers simply follow the crowd. This can be empirically tested using the UK data and quantitative methods similar to the second and third studies. Due to the nature of the project and its particular focus, a variety of factors highlighted in the first study is not investigated in this research. The author finds audit quality as an important area that needs better understanding. Although qualitative research is not biased with a relatively small sample, a larger sample of bankers and auditors may further help the theory in the charitable sector.

Furthermore, in studying accruals-based earnings management, there is a possibility that a mechanical relationship exists between discretionary accruals if discretionary accruals are measured with a measurement error. If DACC represents error then EBDA will carry the same error. This could result in a mechanical relation between DACC and EBDA. Since the data does not provide a further breakdown of accruals e.g. bad debt provision (e.g. Leone Van Horne, 2005), this remains a limitation in the study. However, various parametric tests confirm the small surplus hypothesis.

This study has not focused on the interplay of various manipulation types e.g. accruals-based and real earnings management, or their substitution effect. The author, however, recognises that further study in this regard will provide additional insight into an under-researched area. Another possible area to advance this study is to expand sub-groups according to their sizes, location and closest peer-group within the sub-groups identified by The International Classification of Nonprofit Organisations – ICNPO used for this study.

I also recognise that accruals based earnings management and real activities earnings management could be further understood by studying other accruals and expenses within the broad class of fundraising expenses. Currently, the data is limited in that regard but there is every possibility that in future more data will become available and academics will be interested to test more vigorously what this study has achieved with the given amount of data. It is the first step and there is every possibility that further studies will answer many questions that would not only be interesting for academics but will have significant practical relevance.

While the methodology employed in testing expense classification uses several predictor variables in various ways, there always remains the chance that simultaneity or confounding variables influence the results. Nevertheless, this concern has largely been addressed through several sensitivity tests. The purpose of the study with various analyses should only be viewed as the first step in exploring in depth the misclassification between expenses.

Throughout the study, the existing literature has been used in classifying the charities according to sophistication and donor-beneficiary proximity; however, it cannot be ruled out that charities that do not neatly fall within a specific category are equally amenable to expense misclassification. Similarly, a favourable expense ratio may not be a big concern for a charity which communicates effectively through sufficient disclosures through trustees' report or similar channels.

This study points out the unwelcome practice of financial misreporting, which should be discouraged and strongly reprimanded in a sector that is facing serious trust deficit in the times when it needs to be most effective and trustworthy. In the times of emerging new viruses where famines, geopolitical instability and social inequality are reaching unprecedented heights, the “third sector” can achieve all that neither the

public nor the private sector can achieve. In a world where compassion, care for the elderly, destitute and vulnerable needs should be the priority, a lack of faith in charities will not serve the cause that the world is in dire need of. Indeed, there are some dishonest and deceitful elements who drag the entire sector into disrepute and their acts need to be reprimanded in the most effective and impactful manner. At the same time, this thesis also recognises that most charities tangled in the undesirable financial reporting practices do not intend to cause harm and their managers are not motivated by self-interest; rather they are compelled to act in a way that they see as the only course.

Good corporate governance in charities is fundamental to their success. Due to data unavailability in this regard, this thesis does not include various corporate governance variables such as board independence, CEO compensation, age, gender and race distribution etc. Therefore corporate governance mechanisms is one of the limitations of the thesis and could be an idea for future research.

This thesis can be a useful tool to educate users of charity financial statements. The charity financial statements are specialised fund accounts, different from other business accounts. Assessing or measuring the efficacy of a charity superficially creates a vicious circle that not only casts doubts in the minds of donors over a charity's efficiency and effectiveness but also causes managers to suspect that their funders are fixated on specific 'normal' levels. Just as every human is different and "normal" cannot be objectively defined, various accounting numbers are an inconsistent measurement tool at best and misleading at worst. The author does not take sides in contributing to positive accounting theory but senses that donors and the media who develop unmanageable expectations regarding various ratios and numbers must share some blame. These result in the white lies that are difficult to turn into a true and fair picture of charities.

This is a detailed initial work on all major methods for financial misreporting and invites further research on several avenues pointed out in this thesis. The study of the entire sector is not without its challenges as various charity-specific attributes contribute to a complex mix of challenges. Because most charities are funded through a mix of sources and each funding source may have its own preferences, predicting financial reporting choices is not straightforward. Therefore this endeavour should only be

viewed as a first step in the right direction for many more studies to help practitioners, the regulator, charity managers and most importantly the donors in managing right expectations, making informed decisions and contributing to serving the sector which is in dire need of trust and remains as relevant as ever in history, if not even more.

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